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PROPOSED AMENDMENTS RELATING TO )  
THE SUPERVISION OF AUDITS INVOLVING )  
OTHER AUDITORS ) PCAOB Release No. 2016-002  
AND PROPOSED AUDITING STANDARD— ) April 12, 2016  
DIVIDING RESPONSIBILITY FOR THE AUDIT ) PCAOB Rulemaking  
WITH ANOTHER ACCOUNTING FIRM ) Docket Matter No. 042

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**Summary:** The Public Company Accounting Oversight Board ("PCAOB" or "Board") is proposing to amend its auditing standards to strengthen the requirements that apply to audits that involve accounting firms and individual accountants outside the accounting firm that issues the audit report. The amendments are designed to improve the quality of audits in these circumstances and to align the applicable requirements with the PCAOB's risk-based, supervisory standards.

**Public Comment:** Interested persons may submit written comments to the Board. Comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. Comments also may be submitted by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's website at [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to PCAOB Rulemaking Docket Matter No. 042 in the subject or reference line and should be received by the Board by July 29, 2016.

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Major Proposed  
Amendments:

The Board is proposing for public comment:

- (i) To supersede:
  - AS 1205 (currently AU sec. 543), *Part of the Audit Performed by Other Independent Auditors*; and
  - AI 10, *Part of the Audit Performed by Other Independent Auditors: Auditing Interpretations of AS 1205* (currently AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543*);
  
- (ii) To amend:
  - AS 1201 (currently Auditing Standard No. 10), *Supervision of the Audit Engagement*;
  - AS 1215 (currently Auditing Standard No. 3), *Audit Documentation*;
  - AS 1220 (currently Auditing Standard No. 7), *Engagement Quality Review*; and
  - AS 2101 (currently Auditing Standard No. 9), *Audit Planning*; and
  
- (iii) To issue a new auditing standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*.

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**I. Executive Summary**

Many companies, including many of the largest corporations, have significant international operations. In the audits of such companies, although one firm issues the audit report (*i.e.*, "lead auditor"), important audit work is often performed by other independent accounting firms or other individual accountants (collectively "other auditors").<sup>1</sup> This proposal addresses the lead auditor's responsibilities with respect to other auditors that participate in the audit.

In an audit conducted in accordance with PCAOB standards, the auditor plans and supervises the audit so that the work of all audit participants is properly directed and coordinated, and the results of the work are properly evaluated. When other auditors participate in an audit, it is important for investor protection that the lead auditor assure the audit is performed in accordance with PCAOB standards and that sufficient appropriate evidence is obtained through the work of the lead auditor and other auditors to support the lead auditor's opinion in the audit report.

Working with other auditors can differ significantly from working with individuals in the same firm. For example, the lead auditor and other auditors may work in countries with different business practices, languages, cultural norms, and market conditions. Also, different firms have different quality control systems, and the professional training and experience of the lead auditor may differ from those of the other auditors. These factors can pose challenges in the coordination and communication between the lead auditor and other auditors, including misunderstandings regarding the audit effort needed to meet the objectives of other auditors' work. Without adequate supervision by the lead auditor to address these challenges, deficiencies in other auditors' work can result in deficient audits. Consequently, the lead auditor could issue its audit report without a proper evaluation of the work performed and the evidence obtained in the entire audit and, in some cases, without a reasonable basis for its opinion.

In recent years, some accounting firms have made changes in how they supervise audits that involve other auditors. For example, some firms have encouraged a greater level of supervision by the lead auditor of work performed by other auditors, including frequent, comprehensive communications with other auditors and review of

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<sup>1</sup> This release uses general meanings of "lead auditor" and "other auditors" for ease of explanation. The proposed amendments include more specific definitions of the terms for purposes of applying certain PCAOB standards, as proposed to be amended. For example, the proposed amendments specifically exclude a "referred-to auditor" from the definition of "other auditors." See, *e.g.*, proposed paragraphs .A5 and .A6 of AS 2101 (currently Auditing Standard No. 9), *Audit Planning* (defining "other auditor" and "referred-to auditor.")

other auditor work papers in areas of significant risk. The implementation of these changes to supervision by certain accounting firms appears to have contributed to improvements in the quality of work performed by other auditors.

However, other firms have not significantly changed how they supervise other auditors. In addition, observations from PCAOB oversight activities indicate that further improvements in firm practices may be needed. PCAOB staff continue to identify significant deficiencies in the work of other auditors in critical audit areas, deficiencies that lead auditors did not identify or did not address. Such findings indicate that investor protection could be improved by, among other things, increased involvement in and evaluation of the work of other auditors by the lead auditor.

Because of the lead auditor's central role in an audit involving other auditors, the Board is proposing to amend its auditing standards to strengthen the existing requirements and impose a more uniform approach to the lead auditor's supervision of other auditors. These improvements are intended to increase the lead auditor's involvement in and evaluation of the work of other auditors, enhance the ability of the lead auditor to prevent or detect deficiencies in the work of other auditors, and facilitate improvements in the quality of the work of other auditors. This proposal is intended to strengthen PCAOB auditing standards in the following respects:

- *Taking into account recent changes in auditing practice.* Revising PCAOB auditing standards to take into account recent changes that some firms have implemented to improve their auditing practices would serve to make certain improved practices more uniform among accounting firms for audits that involve other auditors.
- *Applying a risk-based supervisory approach.* Applying a risk-based approach to supervision could result in more appropriate involvement by the lead auditor in supervising the work of other auditors. Unlike the Board's standards for determining the scope of multi-location audit engagements and general supervision of the audit, which require more audit attention to areas of greater risk, the existing standard for using the work of other auditors, AS 1205 (currently AU sec. 543), *Part of the Audit Performed by Other Independent Auditors*, allows the lead auditor, in certain situations, to limit its involvement to certain specified procedures that are not explicitly required to be tailored for the associated risks. Applying a risk-based approach would direct the lead auditor's supervisory responsibilities to the areas of greatest risk.
- *Providing additional direction.* Providing additional direction to the lead auditor on how to apply the principles-based supervisory requirements under PCAOB standards to supervision of other auditors could help

address the unique aspects of supervising other auditors. Additional direction also could help the lead auditor assure that its participation in the audit is sufficient for it to carry out its responsibilities and issue an audit report based on sufficient appropriate evidence.

Additionally, the Board is proposing a new auditing standard for an audit in which the lead auditor divides responsibility for the audit with another accounting firm and refers to the audit report of the other firm in the lead auditor's own audit report. This proposed new standard is designed to carry forward and improve existing requirements that apply in these relatively infrequent circumstances.

The Board is seeking comment on the proposed amendments to its standards (including the new auditing standard), alternatives to those proposed amendments, the economic impacts of the proposal, and data on current practices and potential benefits and costs. This release, including Appendix 4, contains questions on discrete aspects of these matters for which the Board seeks comment. Readers are encouraged to answer questions in the release, and to comment on any aspect of the release or the proposed amendments not covered by specific questions. Readers are especially encouraged to provide the reasoning to support their views and any relevant data.

## **II. Background and Reasons to Improve Auditing Standards**

Many companies have significant operations in jurisdictions outside the country or region of the lead auditor. Among over 4,300 publicly listed companies that reported segment assets or sales in geographic areas outside the country or region of the lead auditor, such assets and sales comprised approximately 38 percent and 45 percent of the total assets and sales, respectively.<sup>2</sup>

When an independent public accountant audits a multinational company, the audit often necessitates the participation of firms or accountants other than the lead auditor,<sup>3</sup> involving perhaps several other accounting firms.<sup>4</sup> The work performed by other auditors can account for a significant share of the audit. For example, based on

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<sup>2</sup> This data is based on information from the most recent audited financial statements of certain public companies filed as of November 15, 2015, sourced from Standard & Poor's. For a more detailed discussion of this information, see section *Geographic Segment Reporting* and note 5 in Appendix 5 of this release.

<sup>3</sup> See Elizabeth Carson, *Globalization of Auditing*, in *The Routledge Companion to Auditing* 23 (David Hay, W. Robert Knechel, and Marleen Willekens eds., 2014).

<sup>4</sup> PCAOB staff analysis of inspections data indicates that the number of accounting firms involved in an audit is, in some cases, greater than 20.

PCAOB oversight data, in audits selected by the PCAOB for inspection that involve other auditors, the other auditors audit on average between one-third and one-half of the total assets and total revenues of the company being audited.<sup>5</sup>

The use of other auditors is especially prevalent among larger companies audited by larger accounting firms. PCAOB oversight data indicate that about 55 percent of audits performed by U.S. global network firms ("GNFs"),<sup>6</sup> and about 30 percent of audits performed by non-U.S. GNFs, were engagements using other auditors.<sup>7</sup> Additionally, about 80 percent of the Fortune 500 issuer audits performed by U.S. GNFs involved other auditors.<sup>8</sup>

Using other auditors can enable lead auditors to leverage the local workforce in the countries where their audit clients operate to assemble a global engagement team with the necessary knowledge, skill, and ability to conduct an effective audit. In addition, for audits of multinational companies, engaging other auditors allows lead auditors to

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<sup>5</sup> The analysis was performed on engagement-level data obtained through PCAOB oversight activities in inspection years 2013–2014. The audits inspected by the PCAOB are most often selected based on risk rather than selected randomly, and these numbers may not represent the use of other auditors across a broader population of companies. *See also Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*, PCAOB Release No. 2015-008, at n. 54 and accompanying text (Dec. 15, 2015) (referencing a PCAOB staff analysis of more than 100 large issuer audits in 2013–2014, which found that a requirement to disclose each other auditor who performed more than 5 percent of the hours on an engagement would reveal one or two other participants per audit on average).

<sup>6</sup> GNFs are the member firms of the six global accounting firm networks that include the largest number of PCAOB-registered non-U.S. firms. This release uses "U.S. GNF" to refer to a GNF member firm based in the United States, and "non-U.S. GNF" to refer to a GNF member firm based outside the United States. Non-Affiliate Firms ("NAFs") are domestic and non-U.S. accounting firms registered with the Board that are not GNFs.

<sup>7</sup> PCAOB staff analysis of data from Audit Analytics and Standard & Poor's. As of December 31, 2015, there were a total of 8,606 public companies trading on U.S. exchanges with an aggregate global market capitalization of about \$33 trillion. U.S. and non-U.S. GNFs audited 56 percent of these companies, which accounted for over 99 percent of global market capitalization.

<sup>8</sup> Based on PCAOB staff analysis of inspections data. The Fortune 500 includes 451 issuers that are audited by U.S. GNFs, and 364 of the audits of those issuers involve other auditors.

accept engagements they may otherwise be unable to undertake, in large part because of restrictions on the activities of foreign auditors that are imposed by many countries.<sup>9</sup>

At the same time, working with other auditors can differ significantly from working with individuals in the same firm. For example, the lead auditor and other auditors may work in countries with different business practices, languages, cultural norms, and market conditions. Also, different firms have different quality control systems, and the professional training and experience of the lead auditor may differ from those of the other auditors (including training and experience in applying PCAOB standards). These factors can pose challenges in the coordination and communication between the lead auditor and other auditors, including misunderstandings regarding the audit effort needed to meet the objectives of the other auditors' work. Without adequate supervision by the lead auditor to address these challenges, deficiencies in other auditors' work can result in deficient audits. Consequently, the lead auditor could issue its audit report without a proper evaluation of the work performed and the evidence obtained in the entire audit and, in some cases, without a reasonable basis for its opinion.

As discussed in Sections B and C below, PCAOB inspections continue to identify significant deficiencies in audit work performed by other auditors that lead auditors did not identify or address. However, there are indications that increased involvement by the lead auditor could enhance the quality of other auditors' work. Additionally, although some firms have made changes to improve their practices for supervising other auditors, other firms have not adopted improvements.

#### **A. Current Requirements**

This section discusses the PCAOB auditing standards that apply specifically when other auditors participate in an audit. Two of the Board's standards, which were adopted at different points in time, take different approaches to how the lead auditor supervises, or uses the work and reports of, other auditors. In 2003, the Board adopted

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<sup>9</sup> See, e.g., Hansrudi Lenz and Marianne L. James, *International Audit Firms as Strategic Networks—The Evolution of Global Professional Service Firms*, in *Economics and Management of Networks: Franchising, Strategic Alliances, and Cooperatives* 367, 369 (Gérard Cliquet, George Hendrikse, Mika Tuunanen, and Josef Windsperger eds., 2007) ("In most countries the right to practice as a certified audit firm is granted only to national firms in which locally qualified professionals have majority or full ownership. Therefore, member firms of an accounting network are locally owned and managed. .... Furthermore, the detailed national rules concerning corporate law and accounting require a high degree of local knowledge, which creates a natural barrier of entry for foreign audit firms without local knowledge.").

AU sec. 543<sup>10</sup> (reorganized as AS 1205<sup>11</sup>), *Part of Audit Performed by Other Independent Auditors*, when it adopted the auditing profession's standards in existence at that time.<sup>12</sup> AS 1205 imposes requirements on a lead auditor (or "principal auditor," in the terminology of AS 1205) that uses the work and reports of other independent auditors that have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements audited by the lead auditor. The specific requirements vary depending upon whether the lead auditor uses the work of other auditors by (i) assuming responsibility for the other auditors' work or (ii) dividing responsibility for the audit with other auditors ("referred-to auditors") and referring to their work in the lead auditor's audit report.<sup>13</sup> Those "divided responsibility" situations are relatively uncommon.

In 2010, the Board adopted Auditing Standard No. 10 (reorganized as AS 1201), *Supervision of the Audit Engagement*, when it adopted eight new auditing standards that set forth the auditor's responsibilities for assessing and responding to risk in an audit.<sup>14</sup> AS 1201 governs the supervision of the audit engagement, including

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<sup>10</sup> In 1963, the American Institute of Certified Public Accountants ("AICPA") issued a codification of auditing standards that included several paragraphs on the use of other auditors' work. In 1971, the AICPA issued Statement on Auditing Procedure No. 45, *Using the Work and Reports of Other Auditors*, and in 1972 it codified the standard in section 543 of the Statement on Auditing Standards No. 1.

<sup>11</sup> In 2015, the PCAOB adopted and the U.S. Securities and Exchange Commission ("SEC") approved the reorganization of PCAOB auditing standards using a topical structure and a single, integrated numbering system. See *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, PCAOB Release No. 2015-002 (Mar. 31, 2015); SEC, *Public Company Accounting Oversight Board; Order Granting Approval of Proposed Rules To Implement the Reorganization of PCAOB Auditing Standards and Related Changes to PCAOB Rules and Attestation, Quality Control, and Ethics and Independence Standards*, Exchange Act Release No. 75935 (Sept. 17, 2015), 80 FR 57263 (Sept. 22, 2015). The reorganized amendments will be effective as of December 31, 2016, but may be used and referenced before that date. See PCAOB Release No. 2015-002, at 21.

<sup>12</sup> See *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (Apr. 18, 2003).

<sup>13</sup> For example, the lead auditor may divide responsibility for the audit with the other auditor if it is impracticable for the lead auditor to review the other auditor's work. See AS 1205.06.

<sup>14</sup> *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release No. 2010-004 (Aug. 5, 2010). These "risk assessment standards" set forth requirements for the

supervising the work of engagement team members. Under existing PCAOB standards, the lead auditor supervises the work of another auditor under AS 1201 in situations not covered by AS 1205. AS 1205 provides that in "situations in which the auditor engages an accounting firm or individual accountants to participate in the audit engagement and AS 1205 does not apply, the auditor should supervise them in accordance with the requirements of AS 1201 ...."<sup>15</sup>

The Board's risk assessment standards largely left in place the preexisting requirements for using the work of other auditors under AS 1205. When the Board adopted the risk assessment standards, it noted that it would likely address the use of other auditors under that approach at a later time.<sup>16</sup>

Figure 1 illustrates an example of a U.S.-based audit that involves other auditors, and the PCAOB auditing standards that apply to the audit. In the example, Accounting Firm 1 involves Accounting Firm 2 by (A) assuming responsibility for the work and reports of Accounting Firm 2 in accordance with AS 1205 or (B) supervising the work of Accounting Firm 2 in accordance with AS 1201. The lead auditor (C) divides responsibility for part of the audit with Accounting Firm 3 in accordance with AS 1205 and refers to Accounting Firm 3 in the lead auditor's audit report on the consolidated financial statements.

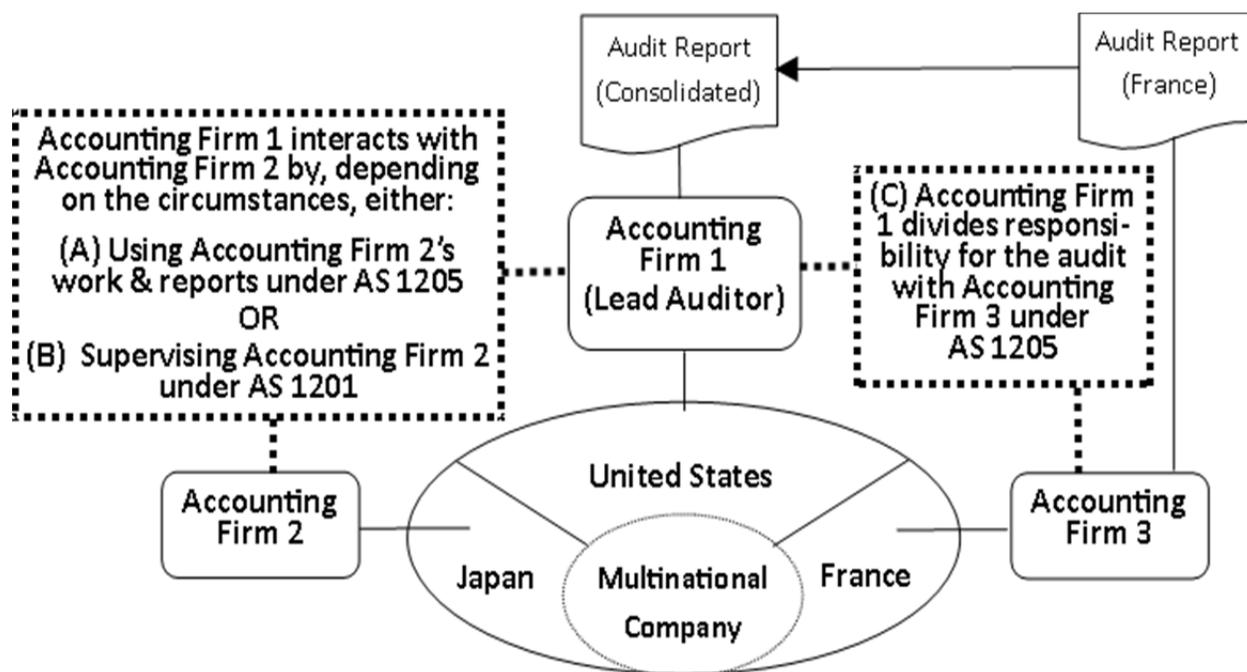
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auditor's assessment of, and response to, the risks of material misstatement in the financial statements. Among other things, the risk assessment standards established risk-based requirements for determining the necessary audit work in multi-location audit engagements.

<sup>15</sup> See the second note to AS 1205.01. For example, AS 1205 does not apply when the participation of another accounting firm in an audit consists solely of observing a physical inventory at a company's warehouse.

<sup>16</sup> See PCAOB Release No. 2010-004, at A10-19 ("[T]he Board has [a] separate standards-setting [project] regarding ... [the use of other auditors], which will include comprehensive reviews of ... AU sec. 543 [reorganized as AS 1205] ... in light of, among other things, observations from the Board's inspection activities ... [and] will likely result in changes to the auditor's responsibilities regarding the auditor's ... use of other auditors, and, in turn, may result in changes to Auditing Standard No. 10 [reorganized as AS 1201].").

**Figure 1. Example of an Audit Involving Other Auditors**



The following discusses AS 1205 and AS 1201 in more detail:

- (A) *Using the work and reports of other auditors under AS 1205 (currently AU sec. 543).* If an auditor uses, and assumes responsibility for, the work and reports of other auditors that audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented, AS 1205 includes the following requirements:<sup>17</sup>
- When significant parts of the audit are performed by other auditors (from the same network of firms as the lead auditor or outside the network), the auditor is required to decide whether its own

<sup>17</sup> In addition, in situations governed by AS 1205, the lead auditor is required by the Board's standard on planning, AS 2101, *Audit Planning*, to determine the locations or business units at which audit procedures should be performed. This also applies to situations in which the auditor divides responsibility with another accounting firm. See AS 2101.14.

participation in the audit is sufficient for it to serve as the lead auditor (or, in the language of AS 1205, the "principal auditor").<sup>18</sup>

- The lead auditor is required to make inquiries about the qualifications and independence of the other auditor and to ascertain through communication with the other auditor:
  - That the other auditor is aware that the financial statements of the component which he or she is to audit are to be included in the financial statements on which the lead auditor will report and that the other auditor's report will be relied upon by the lead auditor;
  - That the other auditor is familiar with the accounting principles generally accepted in the United States, standards of the PCAOB, and relevant financial reporting requirements; and
  - That a review will be made of matters affecting elimination of intercompany transactions and accounts.<sup>19</sup>
- The lead auditor must obtain, review, and retain certain information from the other auditor before issuing the report, including an engagement completion document, a list of significant risks, the other auditor's responses to those risks, the results of the other auditor's related procedures, and significant deficiencies and material weaknesses in internal control over financial reporting.<sup>20</sup>
- The lead auditor also should consider performing one or more of the following procedures: visiting the other auditor, reviewing the audit programs of the other auditor (and, in some cases, issuing instructions to the other auditor), and reviewing additional audit documentation of significant findings or issues in the engagement completion document.<sup>21</sup>

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<sup>18</sup> AS 1205.02.

<sup>19</sup> AS 1205.10.c.

<sup>20</sup> See AS 1205.12.

<sup>21</sup> *Id.*

- (B) *Including the other auditors in the engagement team and supervising their work under AS 1201.* This standard governs the auditor's supervision of an audit engagement, including the work of other auditors who are members of the same engagement team, wherever they are located. AS 1201, as it relates to the supervision of other auditors on the engagement team, contains these requirements:
- The engagement partner and others who assist the engagement partner in supervising the audit should:
    - Inform the engagement team members of their responsibilities for the work they are to perform;
    - Direct the engagement team members to inform the engagement partner and supervisors of important issues arising during the audit; and
    - Review the engagement team members' work.<sup>22</sup>
  - The engagement partner and others who assist the engagement partner in supervising the audit should determine the extent of supervision necessary. Under this standard, requirements for supervision are risk-based and scalable, and the necessary extent of supervision varies depending on, for example, the associated risks of material misstatement, the nature of the work performed, and the qualifications of individuals involved.<sup>23</sup>
  - The engagement partner may seek assistance from other appropriate engagement team members in fulfilling his or her supervisory responsibilities ("supervisory team members").<sup>24</sup> The supervisory team members can be from the partner's firm or from outside the firm.
- (C) *Dividing responsibility for the audit with another accounting firm.* AS 1205 also governs audits in which the lead auditor divides responsibility with another accounting firm that issues a separate audit report on the financial statements of one or more subsidiaries, divisions, branches, components,

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<sup>22</sup> See AS 1201.05.

<sup>23</sup> See AS 1201.06.

<sup>24</sup> See AS 1201.04.

or investments included in the company's financial statements.<sup>25</sup> The requirements of AS 1205 that apply under these circumstances are more limited than the requirements that apply to the lead auditor's use of the work and reports of other auditors when the lead auditor assumes responsibility for that work (discussed in item A above). For example, AS 1205 does not require the lead auditor to obtain, review, and retain certain information from the accounting firm with which the lead auditor divides responsibility for the audit (which is required when the lead auditor assumes responsibility for another firm's work under AS 1205<sup>26</sup>).

## **B. Current Practice**

This section describes the state of practice – including the evolution of audit practices and related inspection findings – that the Board and its staff have observed over the past several years through PCAOB oversight activities (including through observations from audit inspections and enforcement cases). Section C discusses the reasons for change that underlie the amendments the Board is proposing.

### **1. Evolution of Auditing Practice at Accounting Firms**

Auditors around the world, even when they perform audit procedures that are required to comply with PCAOB standards, may be influenced by international and home country auditing standards. With respect to the use of other auditors, the standards of the International Auditing and Assurance Standards Board ("IAASB") and the AICPA's Auditing Standards Board ("ASB"), (International Standard on Auditing ("ISA") 600<sup>27</sup> and AU-C Section 600<sup>28</sup>), establish requirements for "group audits."<sup>29</sup> ISA 600 and AU-C Section 600 were developed in the wake of several significant frauds that

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<sup>25</sup> In these situations, SEC rules require that the other accounting firm's report be filed with the SEC. See Rule 2-05 of Regulation S-X, 17 C.F.R. 210.2-05.

<sup>26</sup> See AS 1205.12.

<sup>27</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, effective for audits of group financial statements for periods beginning on or after December 15, 2009.

<sup>28</sup> AU-C Section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, effective for audits of group financial statements for periods ending on or after December 15, 2012.

<sup>29</sup> Under ISA 600 and AU-C 600, group audits are audits of "group financial statements" consisting of at least two "components." Group audits generally are performed by a "group engagement team" and one or more "component auditors" and may involve a single firm or multiple firms.

occurred in the early 2000s and involved multinational groups of companies, audited by multiple accounting firms.<sup>30</sup>

The IAASB is continuing to assess the need for change in this area. Recently, the IAASB issued a request for comment on identified areas of potential improvement in the standards for group audits,<sup>31</sup> which was informed by, among other things, persistent deficiencies in group audits reported by the International Forum of Independent Audit Regulators.<sup>32</sup>

Meanwhile, the Board has observed through its oversight activities that, after the PCAOB adopted its standards on risk assessment and after the IAASB and ASB issued their new standards, some accounting firms, particularly some of the largest firms that work extensively with other auditors, revised their policies, procedures, and guidance ("methodologies") for using other auditors. These methodologies are based primarily on the requirements of ISA 600 and include certain other procedures for audits under PCAOB standards.<sup>33</sup> The Board also observed differences among firms' methodologies,

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<sup>30</sup> See, e.g., *Koninklijke Ahold N.V. (Royal Ahold)*, A. Michiel Meurs and Cees van der Hoeven, and Johannes Gerhardus Andreae, SEC Accounting and Auditing Enforcement Release ("AAER") No. 2124 (Oct. 13, 2004); *Lernout & Hauspie Speech Products*, AAER No. 1729 (Mar. 4, 2003); *Lernout & Hauspie Speech Products*, AAER No. 1648 (Oct. 10, 2002); *In re Parmalat Securities Litigation*, 04 Civ. 0030 (S.D.N.Y. June 28, 2005). See also Michael J. Jones, ed., *Creative Accounting, Fraud and International Accounting Scandals* (2011) (Part B of the book covers 58 high-profile accounting scandals across 12 countries, including the Royal Ahold and Parmalat cases).

<sup>31</sup> See IAASB, *Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits* (Dec. 2015). See also IAASB, *Work Plan for 2015–2016: Enhancing Audit Quality and Preparing for the Future* (Dec. 2014), 7 ("Concern [with ISA 600] has been expressed about: [t]he extent of the group auditor's involvement in the work of the component auditor ...; [c]ommunication between the group auditor and the component auditor; [a]pplication of the concept of component materiality; [i]dentifying a component in complex situations; and [w]ork effort of the component auditor.").

<sup>32</sup> See paragraph 7 of IAASB, *Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits* (Dec. 2015).

<sup>33</sup> For example, for audits under PCAOB standards, these methodologies often require engagement teams to determine the sufficiency of the firm's participation in the audit. See also Appendix 4 of this release, which compares the Board's proposed amendments to the analogous standards of the IAASB and ASB.

for example, in their approaches to determining whether the firm's participation in an audit is sufficient for it to serve as lead auditor.

In addition, some firms have added requirements that in some respects go beyond those of PCAOB, IAASB, and ASB standards. Other firms, however, have maintained methodologies generally based on AS 1205.<sup>34</sup>

## **2. Observations from Audit Inspections and Enforcement Cases**

PCAOB staff have inspected the work of auditors who use other auditors, for example, by reviewing the scope of the work that is performed by the other auditor, the planning and instructions provided to the other auditor, and the degree of supervision (including review) of the other auditor. The PCAOB also has inspected the work of other auditors, for example, when it conducts inspections abroad and reviews work performed by non-U.S. auditors at the request of a U.S.-based lead auditor. In some cases, PCAOB staff have inspected the work performed by both the lead auditor and other auditors on the same audit. In many cases, but not always, the lead auditor was a U.S. firm while the other auditor was located in another jurisdiction. Observations regarding the work of lead auditors and other auditors from inspections and enforcement actions are described in more detail below.

### **(i) Other Auditors**

Over the past several years, PCAOB inspections staff have observed significant audit deficiencies in the work performed by other auditors. For example, in 2013, inspections staff identified significant audit deficiencies in more than 40 percent<sup>35</sup> of the inspected work performed for lead auditors by non-U.S. GNFs. According to a recent analysis, the rate of deficiencies in inspected audits in 2011–2013 was generally higher for non-U.S. GNFs than for U.S. GNFs.<sup>36</sup>

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<sup>34</sup> See Section IV.A.3 below for a more detailed discussion of the methodologies.

<sup>35</sup> The rates in 2011-2013 were 32, 38, and 42 percent, respectively. See *Audit Committee Dialogue*, PCAOB Release No. 2015-003, at 9 (May 7, 2015) (graph entitled "Deficiencies in Non-U.S. Referred Work"). The issuer audit engagements and aspects of the work inspected are selected based on a number of risk-related and other factors. Due to the selection process, the deficiencies included in inspections reports are not necessarily representative of the inspected firms' issuer audit engagement practice.

<sup>36</sup> See Lewis H. Ferguson, *Big Four Audit Quality Can Differ Widely — Even at the Same Firm* (Nov. 17, 2015) (Mr. Ferguson is a Board member of the PCAOB).

Inspections of the work performed by other auditors have revealed deficiencies such as noncompliance with the lead auditor's instructions and failure to communicate significant accounting and auditing issues to the lead auditor. In addition, deficiencies have been identified in other auditors' compliance with other PCAOB standards governing a variety of audit procedures. These failures in audit performance occurred in critical audit areas that are frequently selected for inspection, including revenue, accounts receivable, internal control over financial reporting, and accounting estimates including fair value measurements. For example, in a number of instances, other auditors failed to perform sufficient procedures in auditing the revenue of a company's business unit, including, with respect to evaluating the revenue recognition policy of a business unit, testing the occurrence of revenue, and testing the operating effectiveness of the business unit's controls over revenue. In a recent Board enforcement case, one other auditor failed both to ensure he was technically proficient and to supervise his assistants in accordance with PCAOB standards.<sup>37</sup> More recently, however, there are some indications of decreasing inspection-observed deficiencies, as discussed in Section II.B.2(iv) below.

**(ii) Lead Auditor**

Over the years, there have been numerous observations from inspections and enforcement activities where the lead auditor failed, under existing PCAOB standards, to appropriately determine the sufficiency of its participation in an audit to warrant serving as lead auditor. These deficiencies occurred at large and small firms, domestic as well as international. In the most egregious examples, the lead auditor failed to perform an audit or participated very little in the audit and instead issued an audit report on the basis of procedures performed by other auditors.<sup>38</sup> In these audits, the auditor failed to appropriately determine that it could serve as the lead auditor when all or a substantial portion of the financial statements were audited by another auditor.

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<sup>37</sup> See *Akiyo Yoshida, CPA*, PCAOB Release No. 105-2014-024 (Dec. 17, 2014).

<sup>38</sup> For enforcement cases, see, e.g., *Michael T. Studer, CPA, P.C. and Michael T. Studer, CPA*, PCAOB Release No. 105-2012-007 (Sept. 7, 2012); *Bentleys Brisbane Partnership and Robert John Forbes, CA*, PCAOB Release No. 105-2011-007 (Dec. 20, 2011); *Dohan + Company, CPAs, Steven H. Dohan, CPA, Nancy L. Brown, CPA, and Erez Bahar, CA*, SEC AAER No. 3232 (Jan. 20, 2011). Some of the standards violated in the enforcement cases cited in this release were predecessor standards to current PCAOB standards. The descriptions of inspection deficiencies are based on certain accounting firm inspection reports (portions of which are available on the PCAOB's website), and on the PCAOB's experience with inspecting different firms.

There also have been findings in which the lead auditor failed to assess, or adequately assess, the qualifications of other auditors' personnel who participated in the audit. For example, PCAOB oversight activities have revealed situations in which the other auditors' personnel lacked the necessary industry experience or knowledge of PCAOB and SEC rules and standards (including independence requirements) and the applicable financial reporting framework to perform the work requested by the lead auditor. Other examples include audits in which: (i) the lead auditor failed to obtain, review, and retain the results of the other auditor's procedures relating to fraud risk factors;<sup>39</sup> (ii) the lead auditor failed to provide specific instructions to other auditors, including detailed audit plans, appropriate modifications to audit plans based on identified risks, the audit objectives to be accomplished, or the need to maintain proper documentation;<sup>40</sup> and (iii) the lead auditor failed to adequately supervise the work of foreign audit staff, in circumstances in which the engagement partner did not speak, read, or write the language used by the foreign staff.<sup>41</sup> More recently, there are indications of increased involvement by some firms in the supervision of other auditors, as discussed in Section II.B.2(iv) below.

### **(iii) Divided Responsibility Audits**

Audits in which the lead auditor divides responsibility with one or more other accounting firms are relatively uncommon.<sup>42</sup> Such division of responsibility between auditors might occur, for example, in the year when an issuer acquires a company

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<sup>39</sup> See *Ron Freund, CPA*, PCAOB File No. 105-2009-007, at 1 (Jan. 26, 2015) (citing a violation of AU sec. 543.12b (reorganized as AS 1205.12b) and observing that "the principal auditor must obtain, and review and retain, the following information from the other auditor: ... b. A list of significant fraud risk factors, the auditor's response, and the results of the auditor's related procedures ....").

<sup>40</sup> See, e.g., *Child, Van Wagoner & Bradshaw, PLLC, Russell E. Anderson, CPA, and Marty Van Wagoner, CPA*, SEC AAER No. 3637 (Feb. 11, 2015); *Sherb & Co., LLP, Steven J. Sherb, CPA, Christopher A. Valleau, CPA, Mark Mycio, CPA, and Steven N. Epstein, CPA*, SEC AAER No. 3512 (Nov. 6, 2013).

<sup>41</sup> See, e.g., *Acquavella, Chiarelli, Shuster, Berkower & Co., LLP*, PCAOB Release No. 105-2013-010 (Nov. 21, 2013); *David T. Svoboda, CPA*, PCAOB Release No. 105-2013-011 (Nov. 21, 2013).

<sup>42</sup> Based on PCAOB staff analysis of SEC filings as of May 26, 2015, Form 10-K filings showed approximately 30 and 38 audits in which the lead auditor divided responsibility with another auditor in fiscal years 2014 and 2013, respectively. Form 20-F filings showed approximately 20 such audits in each of fiscal years 2014 and 2013.

audited by another auditor.<sup>43</sup> Because divided responsibility audits are infrequent, they have not been a significant focus of PCAOB inspections and have not resulted in significant findings.

***(iv) Evolution of Inspection Findings***

As noted above, some firms, particularly larger firms affiliated with global networks, have increased their supervision of other auditors in light of new standards such as ISA 600 and AU-C Section 600. More recently, some larger U.S. firms have made further changes to their audit methodologies in response to deficiencies identified by PCAOB inspections. Specifically, some firms have encouraged a greater level of supervision by the lead auditor, such as frequent comprehensive communications with other auditors and review of other auditors' work papers in the areas of significant risk.

There are some preliminary indications from the Board's inspections that these firms' recent revisions to methodologies to increase the lead auditor's supervision of the other auditor's work may have contributed to a decline in inspection-observed audit deficiencies at foreign affiliates of those firms with respect to work these affiliates perform at the lead auditor's request. In 2014, for example, PCAOB inspections staff observed a decrease in the number of significant audit deficiencies in work performed by other auditors. Thus, the changes to the methodologies of some firms appear to have contributed to some improvements in the quality of audits. However, not all firms have significantly changed their methodologies. Also, PCAOB staff continue to identify significant deficiencies in the work of lead auditors related to the lead auditors' use of other auditors, and deficiencies in the work of other auditors in the U.S. and abroad.

**C. Reasons to Improve Auditing Standards**

After AS 1205 was originally issued, the increasing globalization of business, especially among large public companies, has led to expanded use of other auditors and increasingly significant roles for other auditors within the audit. When other auditors participate in an audit, it is important for investor protection that the lead auditor assure that the audit is performed in accordance with PCAOB standards and that sufficient appropriate evidence is obtained through the work of the lead auditor and other auditors to support the lead auditor's opinion in the audit report. Among other things, this means that the lead auditor should be appropriately involved in the audit so that the work of all audit participants is properly supervised, and so that the results of the work are properly evaluated. Lack of adequate lead auditor supervision can result in deficient audits.

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<sup>43</sup> See, e.g., SEC, Form 10-K for American Airlines Group, Inc., Annual Report for the Fiscal Year Ended December 31, 2013 (Feb. 27, 2014), at 96.

As noted above, some firms have made changes in their audit methodologies regarding the use of other auditors. However, other firms that have not made significant improvements may have greater risk of lower quality audits when they use other auditors.

Additionally, observations from PCAOB oversight activities indicate that further improvements may be needed. PCAOB staff continue to identify deficiencies in the work of other auditors in critical audit areas, deficiencies that lead auditors had not identified or sufficiently addressed. In some cases, these deficiencies occurred even when lead auditors did not violate existing requirements related to the use of other auditors, for example if the lead auditor performed the procedures described in AS 1205 but did not identify these deficiencies. Such findings indicate that investor protection could be improved by, among other things, increased involvement in, and evaluation of, the work of other auditors by the lead auditor.

In order to enhance audit practice among all firms using other auditors, the Board has identified the following areas of potential improvement in the current standards:

- *Taking into account recent changes in auditing practice.* Revising PCAOB auditing standards to take into account recent changes that some firms have implemented to improve their auditing practices would serve to make certain improved practices more uniform among accounting firms for audits that involve other auditors. Including these approaches in the auditing standards also would enable the PCAOB to enforce more rigorous provisions for audits that involve other auditors.
- *Applying a risk-based supervisory approach.* Applying a risk-based approach to supervision could result in more appropriate involvement by the lead auditor in supervising the work of other auditors. Unlike the Board's standards for determining the scope of multi-location audit engagements and general supervision of the audit, which require more audit attention to areas of greater risk, the existing standard for using the work of other auditors allows the lead auditor, in certain situations, to limit its involvement to certain specified procedures that are not explicitly required to be tailored for the associated risks. Applying a risk-based approach would direct the lead auditor's supervisory responsibilities to the areas of greatest risk.
- *Providing additional direction.* Providing additional direction to the lead auditor on how to apply the principles-based supervisory requirements under PCAOB standards to supervision of other auditors could help address the unique aspects of supervising other auditors. Additional direction also could help the lead auditor assure that its participation in the

audit is sufficient for it to carry out its responsibilities and issue an audit report based on sufficient appropriate evidence.

Because of the lead auditor's central role in an audit involving multiple firms, the Board's proposal seeks to strengthen the existing requirements and impose a more uniform approach to the lead auditor's supervision of other auditors. These improvements are intended to increase the lead auditor's involvement in and evaluation of the work of other auditors generally, enhance the ability of the lead auditor to prevent or detect deficiencies in the work of other auditors, and facilitate improvements in the quality of the work of other auditors.

*Question:*

1. 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?

### **III. Discussion of Proposed Amendments**

As described in more detail in Appendix 4, in its proposal the Board intends to strengthen the requirements for lead auditors and provide a more uniform approach to supervision in audits that involve other auditors.<sup>44</sup> The Board's approach in this proposal has been informed by, among other things: (i) observations from Board oversight of firms' current practice; (ii) the IAASB's and ASB's auditing standards and IAASB's post-implementation review;<sup>45</sup> (iii) views expressed by members of the Board's Standing Advisory Group ("SAG"), who have expressed concerns about the robustness of PCAOB auditing standards governing the use of other auditors;<sup>46</sup> and (iv) views

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<sup>44</sup> The proposed amendments would apply to audits of issuers, as defined in Section 2(a)(7) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") (15 U.S.C. 7201(a)(7)), and to audits of brokers and dealers, as defined in Sections 110(3)–(4) of Sarbanes-Oxley (15 U.S.C. 7220(3)–(4)). As discussed further in this release, the PCAOB is seeking comment on whether the proposed amendments should apply to audits of emerging growth companies (see Section V below and Appendix 5) and to audits of brokers and dealers (see Section VI below).

<sup>45</sup> See IAASB, *Clarified International Standards on Auditing—Findings From The Post-Implementation Review* (July 2013).

<sup>46</sup> See the segment of the archived webcast on responsibilities of the principal auditor at the April 7–8, 2010 SAG meeting, available on the PCAOB's website.

expressed by members of a working group of the Board's Investor Advisory Group ("IAG"), who recommended stronger PCAOB auditing standards for the supervision of global audits involving other auditors.<sup>47</sup>

Key aspects of the proposed changes are discussed in this section. The ways in which the proposed amendments would address the need for change from an economic perspective are discussed below in Section IV. In addition, Appendix 4 of this release discusses in more detail the proposed amendments and the proposed new standard.

In brief, the Board's proposal would make the following changes to PCAOB auditing standards:

**A. Amend Existing Requirements**

- Amend AS 1201 (Supervision). The proposal would amend AS 1201 to provide additional direction to the lead auditor on how to apply the principles-based provisions of AS 1201 to supervision of other auditors. Specifically, the proposed amendments would prescribe certain procedures to be performed by the lead auditor with respect to the supervision of the other auditor's work. Under the proposal, the lead auditor would remain responsible for the supervision of the entire audit.
- Amend AS 2101 (Planning). The proposal includes a number of amendments to AS 2101. In general, these amendments incorporate and update requirements from AS 1205 (which is proposed to be superseded), and amend existing requirements to specify that they be performed by the lead auditor. For example, the proposal would incorporate and revise the requirements in AS 1205 for determining the firm's sufficiency of participation in an audit that involves other auditors.
- Amend AS 1215 (Documentation). The proposal would amend AS 1215 to require that the documentation of the office of the firm issuing the auditor's report contain a specified list of other auditors' working papers reviewed by the lead auditor but not retained by the lead auditor.

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<sup>47</sup> See the segment of the archived webcast and accompanying presentation slides on global networks and audit firm governance at the March 16, 2011, IAG meeting available on the PCAOB's website. In addition, at least one comment submitted to the Board in connection with another standard-setting project recommended more rigorous requirements for the planning and supervision of audits involving other auditors. See Letter from the New York State Society of Certified Public Accountants to the Office of Secretary, PCAOB (Feb. 4, 2014) (regarding PCAOB Rulemaking Docket No. 029).

- Amend AS 1220 (Engagement Quality Review). The proposal includes an amendment to AS 1220, which would specifically require the engagement quality reviewer, in an audit involving other auditors or referred-to auditors, to evaluate the engagement partner's determination of his or her firm's sufficiency of participation in the audit.
- To operationalize the proposed requirements, the proposal includes definitions of "engagement team," "lead auditor," "other auditor," and "referred-to auditor." The proposed definitions would be included in AS 1201, AS 2101, and proposed AS 1206.
- The proposal would supersede AS 1205 and thus eliminate the ability of auditors to use the work and reports of other auditors under the requirements of that standard. Thus, if the proposal were adopted, the lead auditor would be required to supervise other auditors under AS 1201 (as it would be amended), the risk-based auditing standard on supervision, when the lead auditor assumes responsibility for the other auditor's work.

**B. Propose a New Auditing Standard for Dividing Responsibility**

The Board is proposing a new, separate standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, to govern circumstances in which the lead auditor divides responsibility for the audit with, and makes reference in the audit report to, another firm ("referred-to auditor"). Currently, AS 1205, which the proposal would supersede, governs those circumstances. Proposed AS 1206 would maintain the requirement that the lead auditor disclose in its report which portion of the financial statements was audited by the referred-to auditor.

In general, the proposed new standard would retain, with modifications, many existing requirements of AS 1205 concerning the lead auditor and referred-to auditor (or, in the terminology of AS 1205, the "principal auditor" and the other auditor with whom the principal auditor divides responsibility for the audit). The proposed new standard would also provide new and substantially revised requirements, such as:

- Obtaining a representation from the referred-to auditor that the referred-to auditor is duly licensed to practice under the laws of the jurisdiction that apply to the work of the referred-to auditor;
- If the referred-to auditor would play a substantial role in the preparation or furnishing of the lead auditor's report, determining whether the referred-to auditor is registered pursuant to the rules of the PCAOB; and

- Disclosing the name of the referred-to auditor in the lead auditor's report.<sup>48</sup>

The proposed modifications are designed to strengthen existing requirements, improve communication between the lead auditor and referred-to auditors, and improve compliance with ethics, independence, and PCAOB registration requirements.

Questions:

2. 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?
3. 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?

#### **IV. Economic Analysis**

The Board is mindful of the economic impacts of its standard setting. The economic analysis describes the baseline for evaluating the economic impacts of the proposal, analyzes the need for the proposal, and discusses potential economic impacts of the proposed requirements, including the potential benefits, costs, and unintended consequences. The analysis also discusses alternatives considered. Because there are limited data and research findings available to estimate quantitatively the economic impacts of discrete changes to auditing standards, the Board's economic discussion is qualitative in nature.

##### **A. Baseline**

This section discusses the economic circumstances and auditing practices that exist today. It addresses: (i) the prevalence of audits involving other auditors and the relative significance of the share of audit work performed by other auditors; (ii) the current requirements that apply to the use of other auditors; (iii) the practices adopted

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<sup>48</sup> Additionally, SEC rules require that the audit report of the referred-to auditor be filed with the SEC. See Regulation S-X Rule 2-05.

by accounting firms that use other auditors; and (iv) the quality of audits that use other auditors, based on observations from regulatory oversight and academic literature.

**1. Prevalence and Significance of Audits Involving Other Auditors**

The use of other auditors to perform audits is widespread, particularly in multinational companies. As discussed in Section II, many companies have significant operations in jurisdictions outside the country or region of the lead auditor. For example, among over 4,300 publicly listed companies sourced from Standard & Poor's that reported segment assets or sales in geographic areas outside the country or region of the lead auditor, such assets and sales comprised approximately 38 percent and 45 percent of the total assets and sales, respectively.<sup>49</sup>

When an audit is performed for a multinational company, the audit often necessitates the participation of firms or accountants other than the lead auditor, involving perhaps several other accounting firms.<sup>50</sup> Academic research indicates that in geographically distributed audits, auditors can compete more effectively in local markets, use location-specific or culture-specific knowledge, and reduce costs by using local labor, which can be less expensive or more specialized (or both). This is particularly true for multinational audits, because engaging other auditors allows lead auditors to accept engagements they may otherwise be unable to undertake.<sup>51</sup>

The use of other auditors is especially prevalent among larger companies audited by larger accounting firms. Recent PCAOB oversight data indicate that about 55 percent of audits performed by U.S. global network firms (*i.e.*, GNFs)<sup>52</sup> and about 30 percent of audits performed by non-U.S. GNFs were engagements using other auditors.<sup>53</sup> The use of other auditors is particularly prevalent among audits of the largest companies, where about 80 percent of Fortune 500 issuer audits performed by U.S. GNFs involved other auditors.<sup>54</sup>

The work performed by other auditors in the locations away from the lead auditor can also account for a significant share of the audit. PCAOB oversight data, for

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<sup>49</sup> See note 2 above.

<sup>50</sup> See note 4 above.

<sup>51</sup> See note 9 above.

<sup>52</sup> See note 6 above.

<sup>53</sup> See note 7 above.

<sup>54</sup> See note 8 above.

example, indicates that, in audits selected by the PCAOB for inspection that involve other auditors, the other auditors audit on average between one-third and one-half of the total assets and total revenues of the company being audited.<sup>55</sup>

## **2. PCAOB Auditing Standards**

As discussed above in Section II.A, two PCAOB auditing standards, AS 1205 and AS 1201, establish requirements for the lead auditor's use or supervision, respectively, of other auditors that participate in an audit. AS 1205 applies when the auditor uses the work and reports of another independent auditor who has audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented. AS 1205 allows the lead auditor (or "principal auditor," in the terminology of AS 1205) to use the results of the other auditor's work after performing specified but limited procedures. When AS 1205 does not apply, the lead auditor is required to supervise the other auditors under AS 1201, which describes supervisory activities necessary for proper supervision of engagement team members. AS 1201 does not have specific provisions for the supervision of other auditors beyond those for supervision of other members of the engagement team, and generally does not specify particular responsibilities that the lead auditor (rather than other auditors who assist the lead auditor) is required to perform.

## **3. Accounting Firm Methodologies**

Some accounting firms, particularly large firms affiliated with global networks, employ methodologies (*i.e.*, policies, procedures, and guidance) primarily based on group audits under ISA 600 and AU-C Section 600. Recently, some of those firms have made changes to their methodologies that, in some respects, go beyond requirements in existing auditing standards. Other accounting firms have maintained methodologies based on AS 1205.

The Board's oversight activities have led to the observation that audit firm methodologies governing the supervision of audits involving other auditors vary, but can be generally grouped into the following three categories.<sup>56</sup>

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<sup>55</sup> See note 5 above.

<sup>56</sup> Although the firm's methodologies described in this section may be generally based on AS 1205 or international standards, they also generally allow other auditors to be supervised by the lead auditor in accordance with AS 1201.

(i) Approaches generally based on AS 1205. Some accounting firms, mostly small firms, have methodologies that generally are based on AS 1205. Key provisions of AS 1205 include requirements that the auditor:

- Determine whether the firm has sufficiently participated in the audit to enable it to serve as lead auditor (or "principal auditor," in the terminology of AS 1205) and report as such on the financial statements;
- Determine whether to assume responsibility for, or make reference in the lead auditor's report to, the work and report of the other auditor;
- Perform certain specified procedures, depending on whether the lead auditor assumes responsibility for the other auditor's work or divides responsibility for the audit with the other auditor, including:
  - Making inquiries concerning the professional reputation and independence of the other auditor (when assuming responsibility or dividing responsibility);
  - Adopting appropriate measures to assure the coordination of the lead auditor's activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements (when assuming responsibility or dividing responsibility); and
  - Obtaining and reviewing certain information and documentation from the other auditor (only when assuming responsibility).

(ii) Approaches based primarily on international standards. Some accounting firms have methodologies that are based primarily on the requirements of ISA 600 and include certain other procedures for audits under PCAOB standards.<sup>57</sup> These methodologies often require greater involvement with the work performed by other auditors<sup>58</sup> than AS 1205 requires.<sup>59</sup>

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<sup>57</sup> For example, for audits under PCAOB standards, these methodologies often require engagement teams to determine the sufficiency of the firm's participation in the audit.

<sup>58</sup> The methodologies that are based on ISA 600 and AU-C Section 600 typically use terms such as "group engagement team" and "component auditors," which may (or may not) refer to separate accounting firms. This release, which focuses on how these methodologies apply to audits involving other auditors, will use the terms "lead auditor" and "other auditor" to describe the methodologies.

<sup>59</sup> See Appendix 4 of this release, which compares the Board's proposed amendments to the analogous standards of the IAASB and ASB.

(iii) Approaches that specify incremental responsibilities of the lead auditor. In the past few years, some large firms have made changes to their methodologies by requiring that the lead auditor perform or consider certain supervisory procedures, beyond AS 1205 and existing international auditing standards, including, for example, procedures to:

- Evaluate specific information about the education and professional experience of the other auditors when gaining an understanding of the other auditor's qualifications;
- Continually update the understanding of the other auditors' qualifications throughout the audit and, if necessary, adjust the extent of the lead auditor's supervision of the other auditors;
- Have the lead auditor's senior engagement team members communicate throughout the audit with the other auditors about important matters that could affect the procedures to be performed by the other auditors; and
- Review specified documentation prepared by the other auditors relating to the planned audit procedures and results of the other auditors' work.

Although practices of engagement teams may differ even within the same firm due to differences in the facts and circumstances of the audit or different auditor judgments, the three categories noted here can serve as useful benchmarks for describing the expected economic impacts of the proposal, discussed below in Section IV.C.

#### **4. *Quality of Audits That Use Other Auditors***

As discussed above in Section II.B.2, PCAOB and SEC oversight of the work performed by other auditors has revealed deficiencies, including noncompliance with the lead auditor's instructions and failure to communicate significant findings or issues to the lead auditor. In addition, deficiencies were identified in other auditors' compliance with other PCAOB standards governing a variety of audit procedures, including in critical audit areas that are usually selected for inspection, such as revenue, accounts receivable, internal control over financial reporting, and accounting estimates including fair value measurements.

Oversight of lead auditors has also resulted in inspection and enforcement observations that the lead auditor failed, under existing PCAOB standards, to appropriately determine the sufficiency of its participation in an audit, and should not have served as the lead auditor. These deficiencies were observed in large and small firms, and in domestic and international audits. There also have been inspection

findings in which the lead auditor failed to assess the qualifications of other auditors' personnel who participated in the audit.<sup>60</sup>

These observed deficiencies, whether related to the work of the other auditor or the lead auditor, could have a negative effect on audit quality even if existing requirements related to the lead auditor's use of other auditors are not violated. This could result in potential risks to investors that are difficult for investors to respond to, because the root cause of the deficiencies (e.g., lack of supervision by the lead auditor of the work of other auditors) may be difficult for investors to observe.

The academic literature provides some insight on the impact of using other auditors on overall audit quality.

Relatively few empirical studies have explicitly examined the relationship between the use of other auditors and audit quality, perhaps because of the relative lack of accessible data. Among the available studies, a published paper and a working paper suggest that audits involving other auditors can exhibit lower overall audit quality than audits that do not involve other auditors, although the research does not clearly indicate whether the decrease in overall audit quality was attributable to the lead auditor or to the other auditors.<sup>61</sup> The small number of recent empirical studies, and the particularity of conditions studied, suggest that the impact of using other auditors on overall audit quality is still a largely unanswered empirical question and may depend on the facts and circumstances of the audit.

It is common for audits using other auditors to take place in different locations, including different countries. Academic research on the challenges of this type of work (but not exclusively on auditing) finds that coordination and communication challenges in geographically distributed work may present challenges: (i) when work is conducted by teams distributed across cities, countries or continents,<sup>62</sup> (ii) when there are

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<sup>60</sup> See Section II.B.2 above.

<sup>61</sup> See Carol Callaway Dee, Ayalew Lulseged, and Tianming Zhang, *Who Did the Audit? Audit Quality and Disclosures of Other Audit Participants in PCAOB Filings*, 90 *The Accounting Review* 1939 (2015) (studying a population of auditors who had not acted as principal auditor for any SEC issuer) (Professor Dee is a former academic fellow and a current consultant at the PCAOB, and her research cited here was undertaken prior to joining the PCAOB); Elizabeth Carson, Roger Simnett, Greg Trompeter, and Ann Vanstraelen, *The Impact of Group Audit Arrangements on Audit Quality and Pricing* (Nov. 2014) (working paper, available in Social Science Research Network ("SSRN")) (based on a study of Australian issuers).

<sup>62</sup> See, e.g., Denise R. Hanes, *Geographically Distributed Audit Work: Theoretical Considerations and Future Directions*, 32 *Journal of Accounting Literature* 1,

differences in language, culture or regulation<sup>63</sup> or (iii) when teamwork is required that involves a number of interdependent activities.<sup>64</sup>

If the cost to the auditor of overcoming these challenges (e.g., through additional supervision of other auditors) exceeds the lead auditor's perception of the benefits of doing so (e.g., in terms of reduced risks of litigation, reputational loss, and regulatory sanction as a result of improving audit quality), then audit quality may suffer.<sup>65</sup> The impact on audit quality could be especially significant because the lead auditor makes important decisions about how the audit is performed, including whether they perform a sufficient portion of the audit to issue the audit report.

*Question:*

4. 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.

**B. Need for the Proposal**

Audit quality is important to investors because audit quality is a component of financial reporting quality, in that high audit quality increases the credibility of financial statements. Conversely, lower audit quality can create uncertainty about the reliability of

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5–7 (2013), for an inter-disciplinary survey of related academic research on challenges in coordinating and managing geographically distributed work.

<sup>63</sup> See *id.* (observing that communication and coordination can be impaired by differences in time, language, and cultural factors that impair the formation of shared norms and understanding across locations).

<sup>64</sup> See, e.g., Kannan Srikanth and Phanish Puranam, *Integrating Distributed Work: Comparing Task Design, Communication, and Tacit Coordination Mechanisms*, 32 Strategic Management Journal 849, 849, 850 (2011) ("We find that interdependence [between different locations] can lower ... performance [at one of the locations]."; "In general, more complex forms of interdependence require greater efforts to achieve coordination.").

<sup>65</sup> See note 61 above.

the company's financial statements and lead investors to require a greater risk premium to invest in securities.<sup>66</sup>

The observed deficiencies in audits that involve other auditors described above may be explained by economic theory. In audits involving other auditors, a market failure<sup>67</sup> is caused, at least in part, by the information asymmetry<sup>68</sup> that exists between investors and the lead auditor regarding the lead auditor's effort in supervising other auditors – investors are uncertain what procedures are performed by the lead auditor to oversee the work of other auditors, leading to uncertainty about audit quality and the risks associated with the use of other auditors.

Because of this information asymmetry, the lead auditor may not be adequately motivated to (i) gather information about the competence of, and work performed by, the other auditor, or (ii) monitor and review (*i.e.*, supervise) the other auditor's work, leading to a moral hazard problem.<sup>69</sup> For example, cost considerations may provide a

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<sup>66</sup> See Turan G. Bali and Hao Zhou, *Risk, Uncertainty, and Expected Returns* (Aug. 2014) (working paper, available at SSRN); and Evan W. Anderson, Eric Ghysels, and Jennifer L. Juergens, *The Impact of Risk and Uncertainty on Expected Returns* 94 *Journal of Financial Economics* 233 (2009).

<sup>67</sup> "Market failure" refers to a situation in which markets fail to function well. What is considered to be a well-functioning market can involve value judgments. One can distinguish between complete and partial market failure: Complete market failure occurs when a market simply does not operate at all, because there are either no willing buyers (but many willing producers) or no willing producers (but many willing buyers). Partial market failure occurs when a market does function but produces either the wrong quantity of a product, or produces a product at the wrong price, or produces products at the wrong level of quality. For example, a market for public company audits which consistently produces deficient audits would be considered a market experiencing partial market failure. See, *e.g.*, Francis M. Bator, *The Anatomy of Market Failure*, 72 *The Quarterly Journal of Economics*, 351 (1958); Steven G. Medema, *The Hesitant Hand: Mill, Sidgwick, and the Evolution of the Theory of Market Failure*, 39 *History of Political Economy* 331 (2007).

<sup>68</sup> "Information asymmetry" may exist in financial markets when there is a separation of ownership (investors) and control (management), because this separation gives company management an informational advantage over investors. Likewise, information asymmetry exists between auditors and investors because the auditor knows his or her own audit quality, which is not observable by the investor.

<sup>69</sup> The term "moral hazard" does not refer to a person's morality, but rather to the incentive an agent may have to take actions that benefit the agent at the expense of harming the principal. Agents with a moral hazard problem may, for example, "shirk"

disincentive to the lead auditor to adequately supervise other auditors.<sup>70</sup> For some auditors, the cost considerations may outweigh an auditor's general incentive to mitigate risks arising from using other auditors. Similarly, moral hazard may occur if the lead auditor inadequately scrutinizes the quality of the other auditor's work or judgment<sup>71</sup> and fails to see reasons to perform additional supervisory procedures.<sup>72</sup>

Adequate supervision of other auditors by the lead auditor is important because the other auditor is likely to have better information (compared to the lead auditor) about its effort and the quality of its work. In the absence of adequate supervision, the other auditor may avoid costly procedures if the other auditor believes the negative consequences of performing low quality audit work, which include the risks of litigation, reputational loss, or regulatory sanction, are comparatively minor.

Strengthening the performance requirements for lead auditors can augment the lead auditor's incentive to monitor the performance of the other auditor through adequate supervision of the other auditor's work. The strengthening of performance requirements could increase the consistency of auditor performance and improve audit quality overall. The proposed amendments to auditing standards are designed to improve audit quality and provide more specificity to investors about the nature and scope of work required to be performed by the lead auditor when using other auditors.<sup>73</sup>

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and not work hard enough on behalf of the principal's interests. See, e.g., Bengt Holmstrom, *Moral Hazard and Observability*, 10 *Bell Journal of Economics*, 74 (1979).

<sup>70</sup> The general effect of cost pressures on audit quality has been studied in the academic literature with varying empirical findings. See, e.g., James L. Bierstaker and Arnold Wright, *The Effects of Fee Pressure and Partner Pressure on Audit Planning Decisions*, 18 *Advances in Accounting* 25 (2001); B. Pierce and B. Sweeney, *Cost-Quality Conflict in Audit Firms: An Empirical Investigation*, 13 *European Accounting Review* 415 (2004).

<sup>71</sup> See, e.g., Jun Han, Karim Jamal, and Hun-Tong Tan, *Auditors' Overconfidence in Predicting the Technical Knowledge of Superiors and Subordinates*, 30 *Auditing: A Journal of Practice & Theory* 1 (2011).

<sup>72</sup> Quality control deficiencies in GNFs may contribute to the problems caused by information asymmetry between the lead auditor and other auditors, since it is common for other auditors to be selected by lead auditors based on network affiliation rather than other factors relevant to audit quality.

<sup>73</sup> The audit provides investors with a credence service. Credence services (or goods) are difficult for consumers to value because their benefits are difficult to observe and measure. Because the seller of the product knows the value of the credence service, information asymmetry between the buyer and seller of the service

*Question:*

5. 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.

**C. Economic Impacts**

The proposal aims to clarify and strengthen the lead auditor's supervisory requirements to provide lead auditors with better direction and a stronger incentive to more consistently produce high quality audits when using other auditors.<sup>74</sup> Everything

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can arise. See Monika Causholli and W. Robert Knechel, *An Examination of the Credence Attributes of an Audit*, 26 Accounting Horizons 631 (2012). See also Alice Belcher, *Audit Quality and the Market for Audits: An Analysis of Recent UK Regulatory Policies*, 18 Bond Law Review 1, 5 (2006) (An "audit is a credence service in that its quality may never be discovered by the company, the shareholders or other users of the financial statements. It may only come into question if a 'clean' audit report is followed by the collapse of the company.").

<sup>74</sup> This proposal and another PCAOB rulemaking (which the Board has adopted) would mitigate different aspects of investors' uncertainty about audits involving other auditors. The current proposal would mitigate investors' uncertainty about audit quality by increasing the requirements for supervising other auditors. In the other rulemaking, the Board adopted new rules and related amendments to auditing standards to require accounting firms to disclose, in audits of issuers, (i) the name of the audit engagement partner, (ii) the name, location, and extent of participation of each other accounting firm participating in the audit whose work constituted at least 5 percent of total audit hours, and (iii) the number and aggregate extent of participation of all other accounting firms participating in the audit whose individual participation was less than 5 percent of total audit hours. See *Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*, PCAOB Release No. 2015-008 (Dec. 15, 2015). The final rules adopted by the Board in that rulemaking were intended to improve the transparency and accountability of issuer audits by adding to the mix of information available to investors. The Board also acknowledged that disclosure of accounting firm participation could allow financial statement users to understand how much of the audit was performed by the firm issuing the audit report and how much was performed by other accounting firms, including those in jurisdictions where the PCAOB has been unable to conduct inspections. See *id.* at 5.

else being equal, the magnitude of the benefits and costs of the proposed amendments are likely to be affected by the nature of the work and the risks involved in the work performed by other auditors, because more complex work and work in areas of greater risk will likely require greater supervisory efforts by the lead auditor. In addition, benefits and costs are likely to be affected by the degree to which accounting firms have already adopted audit practices that are similar to those the proposed amendments would require. For example:

- The proposal would likely have the greatest impact – providing the greatest benefits and imposing the highest costs – on audits using methodologies based on AS 1205 where the lead auditor has a relatively low level of involvement in the work of the other auditor (as described in Section IV.A.3(i) above). These audits may be performed more often by small firms or firms that infrequently conduct audits that involve other auditors.
- The proposal would likely have a more moderate impact – providing fewer benefits and imposing fewer costs – for audits in which the lead auditor currently applies an approach that requires greater involvement in the work of the other auditor than required by AS 1205 (as described in Section IV.A.3(ii) above) but less than what is being proposed. These audits are typically performed by firms whose methodologies are based primarily on international standards and include certain further procedures for audits under PCAOB standards.
- The proposal would likely have the least impact – providing the fewest benefits and imposing the fewest costs – on audits currently performed by firms that have made changes to their methodologies to require supervisory procedures that go beyond the requirements of AS 1205 and international auditing standards and generally require a higher level of involvement in the work of the other auditor (as described in Section IV.A.3(iii) above). The audits performed by some U.S. GNFs are more likely to fall into this category.

The remainder of this section discusses the potential benefits, costs, and unintended consequences that may result from the amendments the Board is proposing.

### **1. Benefits**

The proposal would benefit investors and the public by mitigating the causes of market failure, as discussed above in Section IV.B. The proposal, which is informed by

the issues observed in practice through PCAOB inspection and enforcement activities, would have the following impacts:

- The proposal would increase the accountability of the lead auditor by superseding AS 1205 and amending AS 2101 and AS 1201 to apply in all situations in which the lead auditor involves other auditors. The proposed amendments would include additional requirements to provide the lead auditor with more specificity and clarity about the lead auditor's supervisory responsibilities. The proposed amendments to AS 2101 and AS 1201 would take into account changes in practices and would include incremental enhancements to address audit deficiencies of other auditors that continue to occur in practice.
- The proposal would require a more uniform, risk-based approach to the lead auditor's supervision of other auditors, which should increase the quality of the lead auditor's performance. Currently, lead auditors can apply a range of different approaches for using other auditors without transparency to investors. Under the proposal, lead auditors would supervise other auditors under the amended AS 1201 when they assume responsibility for the other auditors' work. Investors would form expectations of audit quality under the more standardized and improved supervisory framework, and thus have greater certainty about the lead auditor's approach to supervision and the quality of the audit.<sup>75</sup>

More specifically, the proposal would require the lead auditor to determine sufficiency of its participation in the audit based on risk, and be better informed about the qualifications and performance of the other auditor. Proposed amendments to AS 2101, for example, would:

- Require the engagement partner to determine whether the participation of his or her firm is sufficient for the firm to serve as lead auditor, taking into account the risks of material misstatement;

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<sup>75</sup> Academic research indicates that perceived changes in audit quality can change investor behavior, including in response to changes in auditor incentives related to regulatory changes. See, e.g., Jason L. Smith, *Investors' Perceptions of Audit Quality: Effects of Regulatory Change*, 31 *Auditing: A Journal of Practice & Theory* 17 (2012) (finding, in an experiment using MBA students as proxies for investors, that a perceived reduction in audit quality due to regulatory changes resulted in a reduction in equity investment, as investors reacted negatively to the adverse effect of the regulatory changes on auditor incentives to provide audit quality).

- Require the lead auditor to have discussions with other auditors to be informed about potential risks of material misstatement; and
- Require the lead auditor to become appropriately informed about the following regarding the other auditor in determining its extent of supervision: (i) the other auditor's understanding of, and compliance with, pertinent independence and ethics requirements, and compliance with registration requirements; (ii) the other auditor's qualifications with respect to the scope of work to be performed; and (iii) the lead auditor's ability to communicate with the other auditor(s) and gain access to their work papers.

The proposal would also increase the requirements for the lead auditor to monitor and review (*i.e.*, supervise) the work of other auditors. For example, proposed amendments to AS 1201 would require the lead auditor to:

- Provide the other auditor(s) with specific information in writing;
- Obtain and review the other auditor's description of audit procedures it plans to perform;
- Obtain, review, determine, and communicate in writing whether changes to the other auditor's description of audit procedures to be performed are necessary; and
- Determine, based on a review of the other auditor's documentation and written report, information obtained from discussions with the other auditor, and other information obtained during the audit, whether the other auditor complied with the written communications received from the lead auditor and whether additional audit evidence should be obtained by the other auditor.<sup>76</sup>

By improving the requirements for the lead auditor's supervision of other auditors, the proposal aims to increase the likelihood that auditors detect material misstatements in the financial statements.

Investors also may benefit from the proposed amendments indirectly. For example, under existing standards, the auditor is required to communicate with the audit

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<sup>76</sup> The proposed amendments for the supervision of other auditors also include provisions, in proposed Appendix B of AS 1201, that are designed to make the provisions of the standard scalable for multi-tiered audits in which an other auditor supervises additional other auditors.

committee its overall audit strategy, significant risks, and results of the audit, including work performed by other auditors, among other things.<sup>77</sup> Because of the proposed lead auditor's enhanced involvement in the work of other auditors, the quality of communications with audit committees could also be enhanced, specifically as it relates to risks of material misstatements in the financial statements related to the component(s) of the company audited by the other auditor(s). Such enhanced discussions with the audit committee could improve the audit committee's oversight of the audit by highlighting areas where audit committees and companies should increase attention to ensure the quality of their financial statements, including related disclosures. Such increased attention by audit committees and companies could result in higher quality financial reporting, which would benefit investors.

Improving the quality of audits and financial reporting can reduce investors' uncertainty about the information being provided in company financial statements, foster increased public confidence in the financial markets, and enhance capital formation. In particular, improving the quality of the information available to financial markets can increase the efficiency of capital allocation decisions and decrease the cost of capital.<sup>78</sup>

Auditors also may benefit from the proposed requirements, because an increase in audit quality reduces the risk of the auditor's failure to detect material misstatements, and, as a result, the risk of litigation, regulatory sanction or reputational loss faced by auditors could decrease.

The magnitude of these benefits from improved audit quality will likely vary to the extent that current practices reflect the proposed requirements. Based on observations from the Board's oversight activities, most firms would need to enhance their methodologies, but to varying degrees. In general, the greatest changes, and the

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<sup>77</sup> See paragraphs .09–.24 of AS 1301 (currently Auditing Standard No. 16), *Communications with Audit Committees*.

<sup>78</sup> See, e.g., Michael Welker, *Disclosure Policy, Information Asymmetry, and Liquidity in Equity Markets*, 11 *Contemporary Accounting Research* 801 (1995) (increases in equity markets in response to additional disclosure); Partha Sengupta, *Corporate Disclosure Quality and the Cost of Debt*, 73 *The Accounting Review* 459 (1998); Christine A. Botosan and Marlene A. Plumlee, *A Re-examination of Disclosure Level and the Expected Cost of Equity Capital*, 40 *Journal of Accounting Research* 21, 39 (2002); Richard Lambert, Christian Leuz, and Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, 45 *Journal of Accounting Research* 385 (2007) (Professor Leuz is an economic advisor to the PCAOB's Center for Economic Analysis); and Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 *Review of Finance* 1 (2011).

greatest benefits, are likely to occur with lead auditors that need to enhance their methodologies the most.

*Question:*

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

## **2. Costs**

The Board recognizes that imposing new requirements may result in additional costs to auditors and the companies they audit. Auditors may incur certain fixed costs (costs that are generally independent of the number of audits performed) related to implementing the proposal. These include costs to update audit methodologies and tools, and to prepare training materials and conduct training. Large firms are likely to update methodologies using internal resources, whereas small firms are more likely to purchase updated methodologies from external vendors.<sup>79</sup>

In addition, auditors may incur certain variable costs (costs that are generally dependent on the number of audits performed) related to implementing the proposal. These include costs of implementing the proposal at the audit engagement level. For example, to implement the proposed additional requirements for the lead auditor and the engagement quality reviewer, both lead auditors and other auditors may:

- Increase the number of engagement team members (at the lead auditor firm and other firms) and engagement quality reviewer assistants;
- Increase the amount of time incurred by the existing team members and engagement quality reviewers and their assistants; or
- Incur additional costs traveling to a company's locations or business units at which audit procedures are to be performed.

Finally, to comply with the proposed sufficiency of participation requirements, the lead auditor, in some circumstances, may decrease the share of work performed by other

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<sup>79</sup> For context, PCAOB staff analysis of data for the 2013 and 2014 inspections shows that less than two percent of audits performed by U.S. registered firms not affiliated with one of the GNFs (*i.e.*, non-affiliated firms or NAFs) and about ten percent of audits performed by registered non-U.S. NAFs were engagements involving other auditors.

auditors and increase the share of its own work. This possible result is discussed in Section IV.C.3 below as a potential unintended consequence of the proposal.

The proposal's impact on the auditor's fixed and variable costs would likely vary depending on, among other things, whether any of the proposed requirements have already been incorporated in accounting firms' audit methodologies or applied in practice by individual engagement teams. As discussed above, for firms that have implemented approaches that require greater lead auditor involvement, the costs of implementing the proposed requirements may be lower than for firms that currently require less lead auditor involvement. In addition, the proposal's impact could vary based on the size and complexity of an audit. All else equal, anticipated costs generally would be higher for larger, more complex audits than for smaller, less complex audits.

The proposal's impact on the auditor's fixed and variable costs could differ for each particular engagement, depending on which audit approach is currently taken and whether that approach would still be permissible under the proposed requirements. For example, in an audit engagement where the work performed by other auditors involves low-risk areas of the audit and is currently performed under AS 1205, the proposal may have little effect on the lead auditor's supervisory efforts because of the scalable nature of the risk-assessment standards, including AS 1201. At the same time, the lead auditor could experience some increases in cost in such an audit engagement due to the proposed communication requirements.

The economic impact of the proposal on larger accounting firms and smaller accounting firms may differ. For example, larger firms and smaller firms may employ different methodologies and approaches, as discussed above in Section IV.A.3. Additionally, larger accounting firms, which often perform audits involving other auditors, would likely take advantage of economies of scale by distributing fixed costs (e.g., updating audit methodologies) over a larger number of audit engagements. Smaller accounting firms, which less often perform audits that involve other auditors, would likely distribute their fixed costs over fewer audit engagements. However, larger accounting firms would likely incur more variable costs due to the proposal than smaller firms would, because larger firms more often perform larger audits and audits involving other auditors. It is not clear whether these costs (fixed and variable), as a percentage of total audit costs, would be greater for larger or for smaller accounting firms.

For audits that involve divided responsibility (in which the lead auditor divides responsibility for the audit with another accounting firm), the anticipated impact of the proposal on the lead auditor's costs is not likely to be significant. Only about 50 audits per year involve divided responsibility, and the proposed changes to PCAOB standards that apply to those scenarios are not as significant as other changes included in the proposal.

In addition, companies being audited may incur costs related to the proposed amendments, both directly and indirectly. Companies, including audit committees and financial statement preparers, could incur direct costs from engaging with or otherwise supporting the auditor performing the audit. For example, some companies could face costs of producing documents and responding to additional auditor requests for audit evidence, due to more rigorous evaluation of audit evidence by lead auditors. Companies may incur additional costs if audit committees need to discuss with the auditor additional information provided as a result of the proposal. To the extent that auditors incur higher costs to implement proposed requirements and are able to pass on at least part of the increased costs through an increase in audit fees, companies could incur an indirect cost.<sup>80</sup>

*Question:*

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

**3. Unintended Consequences**

In addition to the benefits and costs discussed above, the proposed amendments could have unintended economic impacts. The following discussion describes potential unintended consequences considered by the Board and steps the Board has taken to mitigate the negative consequences.

First, unlike AS 1205 (which would be superseded by the proposal), AS 1201 does not contain a statement that "the other auditor remains responsible for the performance of his own work and for his own report." Thus, it is possible that the other auditor could feel less accountable given that the proposal focuses the responsibility for providing direction and supervision of the other auditor on the lead auditor. If this occurred, audit quality could decrease. To mitigate this potential consequence, the proposal includes a requirement that the lead auditor obtain from the other auditor a

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<sup>80</sup> It is not clear to what extent the increased auditor performance requirements would result in increased audit fees. The Board is aware of public reports that have analyzed historical and aggregate data on audit fees and which suggest that audit fees generally have remained stable in recent years, notwithstanding the fact that the Board and other auditing standard setters have issued new standards during that period. See, e.g., Audit Analytics, *Audit Fees and Non-Audit Fees: A Thirteen Year Trend* (Aug. 2015). Because amendments to, and adoption of, new Board standards typically involve discrete parts of an audit, which are not accounted for or priced on a standard-by-standard basis, it is difficult to obtain data that isolate the costs of particular new audit standards and that would be comparable between firms.

written report describing the other auditor's procedures, findings, conclusions, and if applicable, opinion. Notably, under the proposal, the other auditor would continue to remain responsible for, among other things, obtaining sufficient appropriate audit evidence to support its written report describing the other auditor's procedures, findings, conclusions, and if applicable, opinion. In addition, the other auditor's work would be subject to the heightened supervision of the lead auditor under the amended standards, which would reduce the other auditor's opportunities for performing inferior work without detection. Finally, the other auditor's work would continue to be subject to PCAOB oversight activities if they are a registered firm.

Second, because lead auditor personnel would be required to perform additional supervisory responsibilities, such team members might have less time to perform other work on the same engagement. This could potentially reduce the likelihood that the auditor detects material misstatements in the portion of the financial statements for which the lead auditor performs procedures and could potentially lead to inefficient allocation of audit resources. The proposal intends to mitigate this possible unintended consequence by proposing risk-based supervision requirements. Under the proposal, the additional supervisory procedures would be required for the work performed by the other auditor to provide the lead auditor with a basis for concluding whether the financial statements are free of material misstatement. Thus, under the proposal, the lead auditor would focus its efforts on audit areas with the greatest risk of material misstatement to the financial statements. This should result in an appropriate focus on the riskiest audit areas, whether those areas are audited by the lead auditor directly or by another auditor under the lead auditor's supervision.

Third, in response to (i) the potential costs or any practical difficulties of supervising other auditors under the proposed amendments or (ii) the proposed sufficiency of participation requirements, the lead auditor, in some circumstances, may decrease the share of work performed by other auditors and increase the share of its own work. To the extent the other auditors possess knowledge of important country-specific information, limiting their involvement in the engagement may negatively impact audit quality. This potential outcome, however, would be contrary to the following existing PCAOB standards:

- "Auditors should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability so that they can evaluate the audit evidence they are examining";<sup>81</sup>

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<sup>81</sup> Paragraph .06 of AS 1015 (currently AU sec. 230), *Due Professional Care in the Performance of Work*.

- "The knowledge, skill, and ability of engagement team members with significant engagement responsibilities should be commensurate with the assessed risks of material misstatement";<sup>82</sup> and
- Firms are required to have policies and procedures in place that provide reasonable assurance that the firm will undertake only those engagements that the firm can reasonably expect to be completed with professional competence.<sup>83</sup>

In addition, legal restrictions in some countries that prohibit a foreign auditor from providing professional services in the country could limit a foreign lead auditor's ability to take on more work and assign less work to the other auditor in the country.

Fourth, some auditors who currently use the other auditor's work under AS 1205 may view compliance with the proposed supervision under AS 1201 as too costly and decide instead to divide responsibility for the audit with the other auditor. There are limited research findings available regarding the division of responsibility,<sup>84</sup> and it is not clear whether an increase in audits with divided responsibility would adversely affect audit quality. In order to provide transparency about such situations, however, the proposal would require that, in a divided-responsibility scenario, the lead auditor disclose in its audit report: (i) that part of the audit is performed by another accounting firm; (ii) the magnitude of the portion of the company's financial statements audited by the referred-to auditor; and (iii) the referred-to auditor's name.<sup>85</sup>

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<sup>82</sup> Paragraph .05a of AS 2301 (currently Auditing Standard No. 13), *The Auditor's Responses to the Risks of Material Misstatement*.

<sup>83</sup> Paragraph .15 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

<sup>84</sup> One academic study indicates that financial statements with audit reports containing explanatory language (including, among others, the division of responsibility disclosure) were more likely to be subsequently restated than financial statements without such language. See Keith Czerney, Jaime J. Schmidt, and Anne M. Thompson, *Does Auditor Explanatory Language in Unqualified Audit Reports Indicate Increased Financial Misstatement Risk?*, 89 *The Accounting Review* 2115 (2014).

<sup>85</sup> SEC Regulation S-X also currently requires that, in divided responsibility scenarios, the other auditor's report be filed with the SEC. See Regulation S-X Rule 2-05 ("If, with respect to the examination of the financial statements, part of the examination is made by an independent accountant other than the principal accountant and the principal accountant elects to place reliance on the work of the other accountant and makes reference to that effect in his report, the separate report of the other accountant shall be filed.").

Fifth, because the proposal would require performing additional supervisory procedures, it could unintentionally decrease competition in the audit market because smaller firms, which lack economies of scale, may be less able to compete with larger firms in the market for audits that require or would benefit from the involvement of other auditors. This is most likely to occur in the segment of the audit market serving larger and more complex companies since this is the segment more likely to involve decentralized operations or subsidiaries. However, it is the Board's understanding, based on PCAOB oversight activities, that smaller firms already perform relatively fewer audits that involve other auditors than larger firms. Thus, any impact on competition in the overall audit market is likely to be relatively small.

Finally, it might be possible that some audits currently conducted under AS 1205 would not benefit from the additional supervisory requirements being proposed. This situation could occur, for example, on very simple low-risk audits that involve highly qualified other auditors. A potential unintended consequence of the proposal would be that the lead auditor could incur additional costs to comply with the additional proposed supervisory requirements without yielding a corresponding benefit. This inefficient outcome is mitigated by the risk-based and scalable aspects of the proposed requirements, which rely on the lead auditor to make judgments about the nature and extent of supervision of other auditors based on risks.

*Questions:*

8. 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?
9. 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?
10. 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?

**D. Alternatives Considered**

The development of the proposal involved considering a number of alternative approaches to address the problems described above. This section explains: (i) why

standard-setting is preferable to other policy-making approaches, such as providing interpretive guidance or enhancing inspection or enforcement efforts; (ii) other standard-setting approaches that were considered; and (iii) key policy choices made by the Board in determining the details of the proposed standard-setting approach.

**1. *Why Standard-Setting Is Preferable to Other Policy-Making Approaches***

The Board's policy tools include alternatives to revising the standard setting, such as issuing additional interpretive guidance or an increased focus on inspections or enforcement of existing standards. The Board considered whether providing guidance or increasing inspection or enforcement effort would be effective corrective mechanisms to address concerns with the supervision of other auditors and the sources of market failure discussed in Section IV.B. The Board 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. Interpretive guidance inherently provides additional information about existing standards. Inspection and enforcement actions take place after insufficient audit performance (and potential investor harm) has occurred. Devoting additional resources to guidance, inspections, and enforcement activities without improving the relevant performance requirements for auditors would, at best, focus auditors' performance on existing standards and would not gain the benefits associated with improving the standards. The Board's approach reflects its conclusion that standard setting is needed to fully achieve the benefits resulting from improvement in audits involving multiple auditors.

**2. *Other Standard-Setting Alternatives Considered***

The Board considered certain standard-setting approaches, including: (i) retaining the existing framework but requiring the lead auditor to disclose which supervisory standard (AS 1201 or AS 1205) was used to oversee the work of other auditors; (ii) amending AS 1205 or extending the approach in AS 1205 to cover all arrangements involving other auditors; (iii) developing a new standard, in addition to the Board's risk assessment standards, that would address all arrangements with other auditors; or (iv) the proposed approach which comprises amending AS 1201, and describing the requirements for the divided-responsibility audits in a new proposed standard AS 1206.

**(i) *Disclosing Which Standard Applies Under Existing Framework***

The Board considered but is not proposing a requirement that the lead auditor disclose, in the audit report or elsewhere, whether the lead auditor applied AS 1205 or AS 1201 to its use of the other auditor. A disclosure approach would not achieve the

benefits of applying AS 1201 (as amended by the Board's proposal) to all audits that involve other auditors, and inconsistencies between firms in their approaches to the oversight of other auditors would remain.<sup>86</sup>

From an economic perspective, it would be more efficient and effective to address the reasons for change described above in this release by amending existing auditing standards on supervision than by disclosing which standard applies. The proposed amendments would directly address the lead auditor's incentives, whereas disclosing which standard applies would do so indirectly at best. For disclosure to sufficiently change the lead auditor's incentives, investors would need to apply significant market pressure on auditors to improve their supervisory procedures beyond current requirements. This approach seems unlikely given the wide dispersion of share ownership among investors and the costs of engaging in collective action.

***(ii) Amending AS 1205***

The Board considered, but is not proposing, two alternative approaches that would amend rather than supersede AS 1205. The first approach would have amended AS 1205 to strengthen its supervisory requirements but otherwise retain the existing two-standard framework in which an engagement involving other auditors could be governed by either AS 1205 or AS 1201. The second approach would have amended AS 1205 to extend its application to all arrangements involving other auditors such that AS 1201 would no longer apply.

The Board determined that the risk-based supervision approach in AS 1201 promotes a more appropriate involvement by the lead auditor than the approach in AS 1205. The supervisory approach in AS 1201 requires that the level of supervision be commensurate with the associated risks, and that would apply to supervision of the other auditors' work. From an economic perspective, the risk-based approach, which is now a well-established and understood auditing practice, requires the auditor to take into account the facts and circumstances of an audit engagement to inform a variety of resource allocation decisions, including the nature, timing, and extent of its supervision of other auditors. This approach enables the lead auditor to better align its supervisory effort with the riskiest areas of the audit and thus provide more risk mitigation benefit to investors. Similarly, the other auditor's communication of important and relevant information to the lead auditor allows the lead auditor to make better-informed decisions regarding the work of the other auditor.

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<sup>86</sup> In a separate rulemaking, the Board has adopted rules and amendments to its auditing standards to require that the auditor, among other things, disclose information about other accounting firms that participated in the audit. See note 74 above.

In contrast, AS 1205 employs an approach that allows the lead auditor to use the work of other auditors based on the performance of certain limited procedures that are not explicitly required to be tailored for the associated risks. Thus, the approach of AS 1205 would not address the problems described in this release as effectively as the supervisory approach of AS 1201 would.

**(iii) *Developing a New Standard for All Arrangements with Other Auditors***

The Board also considered developing a new, separate standard to govern all arrangements with other auditors. Although the IAASB and ASB adopted new standards for group audits, ISA 600 and AU-C Section 600, the Board believes that proposing a separate standard is not necessary for the vast majority of audits involving other auditors in which the lead auditor uses the other auditors' work. (The proposal would describe requirements for divided-responsibility audits in a separate standard, AS 1206.) The risk-based standard on supervision is already applicable to some audits involving other auditors, appropriately scalable, familiar to auditors, and integrated with the Board's other risk assessment standards. Accordingly, the proposed approach involves a less drastic approach of enhancing the existing standard through targeted amendments imposing certain requirements on the lead auditor, rather than creating an entirely new standard.

**(iv) *Amending to Address Oversight of Multi-location Engagements***

The Board considered, but is not proposing, amendments to existing standards that would apply to oversight of multi-location audit engagements generally (including multi-location engagements performed by a single firm), in addition to amendments that apply to the auditor's use of other auditors. The Board is not proposing such amendments because other PCAOB auditing standards already specifically address multi-location engagements.<sup>87</sup> Additional requirements for these audits, along with

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<sup>87</sup> Requirements for multi-location engagements are specifically addressed in risk assessment standards adopted by the Board in 2010. See, e.g., AS 2101 (currently Auditing Standard No. 9), *Audit Planning*; AS 2105 (currently Auditing Standard No. 11), *Consideration of Materiality in Planning and Performing an Audit*; AS 2110 (currently Auditing Standard No. 12), *Identifying and Assessing Risks of Material Misstatement*; AS 2301 (currently Auditing Standard No. 13), *The Auditor's Responses to the Risks of Material Misstatement*. See also AS 2401 (currently AU sec. 316), *Consideration of Fraud in a Financial Statement Audit*; AS 1215 (currently Auditing Standard No. 3), *Audit Documentation* (Basis for Conclusions paragraphs A60 – A67); AS 6115 (currently Auditing Standard No. 4), *Reporting on Whether a Previously Reported Material Weaknesses Continues to Exist*.

requirements for supervising other auditors, could create unnecessary complexity and redundancy with existing requirements. Finally, greater concerns have arisen through the Board's oversight observations of audits involving other auditors than of single-firm multi-location engagements.

### **3. Key Policy Choices**

Given a preference for amending AS 1201, the Board considered different approaches to addressing key policy issues.

#### **(i) Sufficiency of the Lead Auditor's Participation**

To increase the likelihood that a lead auditor performs audit procedures for a meaningful portion of the financial statements based on risk, the Board's proposing to require that the lead auditor determine the sufficiency of its participation in all audits that involve other auditors. Sufficient participation by the lead auditor is important because it helps the firm issuing the audit report to obtain sufficient appropriate evidence in the highest risk areas of the audit. In evaluating the alternative approaches, the Board weighed the practical implications of specific criteria or conditions on the efficiency and effectiveness of the audit. The Board also evaluated, among other things, relevant information from its oversight activities and views from its SAG members.<sup>88</sup>

The proposed requirement for determining sufficiency of participation would be based on the risks of material misstatement associated with the portion of the financial statements audited by the firm, 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. Ordinarily, the lead auditor would need to audit the location at which the primary financial reporting decisions were made and the consolidated financial statements were prepared in order to address the risks related to those important judgments and activities, and a sufficient number of locations to cover a greater portion of the risks than any of the other audit firms performing procedures on the audit. Under this proposed approach, the criterion for the determining sufficiency of participation would be aligned with the principle for determining the scope of work in a multi-location audit, as both would be based on the risk associated with the respective locations or business units.

The Board considered, but is not proposing, a requirement based on a quantitative threshold, such as the number of material locations or percentage of assets or operations to be audited by the lead auditor. A determination of sufficiency based on quantitative thresholds would impose constraints that could limit the effectiveness and efficiency of the audit. For example, if a threshold were too high, in an audit of a

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See note 46 above.

company with highly dispersed international operations conducted by multiple firms, none of the firms participating in the audit could serve as the lead auditor. Instead, the proposal uses a risk-based criterion that considers materiality as well as other relevant factors.

Under the proposed risk-based criterion for determining sufficiency of participation, the lead auditor ordinarily would need to audit the location at which the primary financial reporting decisions were made and the consolidated financial statements were prepared in order to address the risks related to those important judgments and activities. The Board considered, but is not proposing, prescribing additional criteria for determining sufficiency of participation based on the location of the company's principal assets, principal operations, and corporate offices. Such additional criteria were not proposed because the risk-based criterion in the proposed amendments already encompasses the consideration of those factors to the extent they pose risks of material misstatement to be addressed in the audit.

***(ii) Lead Auditor's Supervisory Requirements***

When other auditors are involved in an audit, the Board considered whether the lead auditor (which includes the engagement partner and other supervisory personnel of the firm issuing the audit report) should be specifically required to perform certain supervisory procedures, and what the scope of any such procedures should be. Currently, PCAOB standards allow the engagement partner to seek assistance from appropriate engagement team members in fulfilling his or her supervisory responsibilities, but the standards for supervision do not specify which supervisory procedures must be performed by the lead auditor.

In many audits, engagement partners seek assistance in fulfilling their supervisory responsibilities from engagement team members at other accounting firms that participate in the audit. By increasing the lead auditor's monitoring responsibilities, the proposed supervisory procedures for the lead auditor could enhance the ability of the lead auditor to prevent or detect deficiencies in the work of other auditors, and facilitate improvements in the quality of the work of other auditors. Thus, these proposed requirements aim to change auditor behavior by strengthening the incentives of the lead auditor, thus addressing the moral hazard problem discussed above.

The Board considered, but is not proposing, requiring that the lead auditor gain an understanding of the qualifications of all engagement team members outside the lead auditor's firm. Instead the proposal would require the lead auditor to gain an understanding of the knowledge, skill, and ability of the other auditors who assist the engagement partner with supervision. The proposed requirement should result in a more effective allocation of audit resources by focusing the lead auditor's efforts on the engagement team members outside the firm with whom the lead auditor primarily

communicates and who are responsible for supervising the work performed by other engagement team members.

The Board also considered, but is not proposing, requiring the lead auditor to determine the nature, timing, and extent of audit procedures to be performed by the other auditors. Instead, the proposal would require that the lead auditor determine the scope of the work of other auditors and review the other auditor's description of nature, timing, and extent of audit procedures. The proposal also would require the lead auditor determine whether there are any changes necessary to the procedures and communicate them to the other auditors. The proposed approach would be more effective as the lead auditor generally has better visibility of the entire audit and the other auditors have more detailed information than the lead auditor about audit areas in which they are involved.

*Questions:*

11. 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?
12. Are there additional economic considerations associated with this proposal that the Board should consider? If so, what are those considerations?

**V. Considerations for Audits of Emerging Growth Companies**

The proposed amendments would apply to audits of issuers, as defined in Section 2(a)(7) of Sarbanes-Oxley. As discussed below, the PCAOB is seeking comment on whether the proposed amendments should apply to audits of emerging growth companies ("EGCs"), as defined in Section (3)(a)(80) of the Securities and Exchange Act of 1934 ("Exchange Act").

Pursuant to Section 104 of the Jumpstart Our Business Startups ("JOBS") Act, any rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."<sup>89</sup> As a result of the JOBS Act, the rules and related amendments to

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<sup>89</sup> See Pub. L. No. 112-106 (Apr. 5, 2012). See Section 103(a)(3)(C) of Sarbanes-Oxley (15 U.S.C. 7213(a)(3)), as added by Section 104 of the JOBS Act.

PCAOB standards the Board adopts are subject to a separate determination by the SEC regarding their applicability to audits of EGCs.

The data presented in Appendix 5 indicate that, among other things, a majority of EGCs are smaller public companies that are relatively new to the SEC reporting process. This indicates that there is less information available to investors regarding such companies relative to the broader population of public companies. Academic research indicates that, on average, investors are less informed about companies that are smaller and that these companies are followed by fewer analysts.<sup>90</sup> To the extent that EGCs exhibit one or more of these properties, investors are likely to have less information available about EGCs relative to the broader population of public companies. Accordingly, EGCs are likely to have a greater relative degree of information asymmetry between management and investors.

When confronted with information asymmetry, investors may require a larger risk premium, and thus increase the cost of capital to companies.<sup>91</sup> Reducing information asymmetry, therefore, can lower the cost of capital to companies, including EGCs, by decreasing the risk premium required by investors.<sup>92</sup>

To benefit from reducing information asymmetry, smaller public companies, including EGCs, must also consider the cost of informing investors. As noted earlier, larger auditors may be able to implement the proposed requirements more cost-effectively than smaller auditors due to greater economies of scale in implementing the new requirements. Thus, audit fees for public companies of any size audited by larger accounting firms may, all else equal, increase to a lesser extent proportionally than audit fees for public companies audited by smaller accounting firms.

Compared to the broader population of public companies with operations outside the country of their lead auditor (*i.e.*, foreign operations), EGCs – a majority of which are smaller companies – are significantly less likely to operate in multiple countries.<sup>93</sup> To the

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<sup>90</sup> See, e.g., V. V. Chari, Ravi Jagannathan, and Aharon R. Ofer, *Seasonalities in Security Returns: The Case of Earnings Announcements*, 21 *Journal of Financial Economics* 101 (1988); Michael J. Brennan and Avanidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 *Journal of Financial Economics* 361 (1995).

<sup>91</sup> See note 66 above and accompanying text.

<sup>92</sup> For a discussion of how increasing reliable public information about a company can reduce risk premium, see David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 *The Journal of Finance* 1553 (2004).

<sup>93</sup> See Appendix 5, section *Geographic Segment Reporting*.

extent that audits of EGCs with foreign operations involve other auditors, the proposed requirements for such audits are likely to affect a smaller proportion of EGCs than the broader population of public companies. This also means that EGCs generally are less likely to incur costs or experience benefits from the proposal as much as the broader population of public companies. However, for EGCs with foreign operations, the percentage of sales and assets outside the country of the lead auditor is significantly higher than for the broader population of public companies with foreign operations.<sup>94</sup> All else being equal, these EGCs are more likely to incur costs or experience benefits from the proposal as much as, or to a greater extent than, the broader population of public companies.

For those small companies (including EGCs) that are affected, even a small increase in audit fees could negatively affect their profitability and competitiveness. Depending on the magnitude of the cost increase relative to the profitability of the company and the capital formed by investors, the additional audit-related costs could deter companies, in certain circumstances, from entering public markets if those costs weigh on their potential profitability. The increase in costs also could encourage public companies to deregister their securities for the same reasons, as regulatory costs may be determinants of a company's choice to exit public markets if the perceived benefits from reduced costs of capital do not outweigh the costs borne due to regulation.<sup>95</sup>

*Question:*

13. 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?

**VI. Applicability of the Proposed Requirements to Audits of Brokers and Dealers**

The proposed amendments would apply to audits of brokers and dealers, as defined in Sections 110(3)-(4) of Sarbanes Oxley. As discussed below, the PCAOB is seeking comment on whether the proposed amendments should apply to audits of brokers and dealers.

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<sup>94</sup> *Id.*

<sup>95</sup> See, e.g., Christian Leuz, Alexander Triantis, and Tracy Yue Wang, *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 *Journal of Accounting & Economics* 181 (2008).

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") provided the Board with oversight authority with respect to audits of brokers and dealers that are registered with the SEC. In light of the authority granted to the Board by the Dodd-Frank Act, the SEC adopted on July 30, 2013, amendments to Rule 17a-5 under the Exchange Act to require, among other things, that audits of brokers' and dealers' financial statements be performed in accordance with the standards of the PCAOB for fiscal years ending on or after June 1, 2014. Thus, the auditing standards currently governing the use of other auditors in audits of brokers and dealers are the same as those for audits of issuers. The Board is considering whether the proposed requirements should apply to audits of brokers and dealers.

Information obtained by the Board's staff indicates there are no brokers or dealers that are currently issuers, although some of the largest brokers and dealers are subsidiaries of issuers. Preliminary information from PCAOB inspections indicates that other auditors are used infrequently in audits of brokers and dealers. The small portion of audits of brokers and dealers that involve other auditors generally are also performed in conjunction with audits of the issuer parent. The Board seeks feedback from the public on these observations regarding the use of other auditors in audits of brokers and dealers.

For brokers and dealers that are issuer subsidiaries, the discussion of the need for the proposal and related economic considerations in Section IV generally apply. The rest of this section discusses the economic considerations associated primarily with brokers and dealers that are not issuer subsidiaries.

The brokers and dealers that are not issuer subsidiaries are typically owned by an individual or non-issuer entity that holds a controlling interest. Thus, the owners of brokers and dealers are closely related to the management of the entity, and have direct access to management and the auditor. In those situations, the market failure addressed by the audit of brokers and dealers is distinct from the market failure addressed by the audit of public companies (issuers). While in both cases audits are intended to mitigate problems related to information asymmetry, the parties with whom information asymmetries exist differ. In the case of public company audits, the audit is intended to mitigate the problems related to the information asymmetry between investors (including shareholders and other users of financial statements, including the public) and the management of the public company. In the case of audits of brokers and dealers, the audit is intended also to mitigate the problems related to the information asymmetry between the customers of the brokers and dealers, who use the services of the brokers and dealers to invest in securities and other financial instruments, and the management of the brokers and dealers. In addition, it may also help attenuate the information asymmetry between management and the other users of financial statements, such as counterparties and regulatory authorities.

The information asymmetry between the management of brokers and dealers and their customers about the brokers' and dealers' financial condition may be significant. Unlike the owners of brokers and dealers, who themselves may be managers and thus have minimal or no information asymmetry, customers of brokers and dealers are likely to be large in number, geographically distributed, and not expert in the management or operation of brokers and dealers. Such information asymmetry between the management and the customers of brokers and dealers makes the role of auditing important to enhance the reliability of financial information.

The proposal is not expected to have a widespread impact on the audits of brokers and dealers that are not issuer subsidiaries, since there are likely few instances in which such audits involve the use of other auditors. However, in those instances in which other auditors are used, the proposed requirements may provide a benefit to the customers of the broker or dealer whose auditor does use other auditors. Because of the scalability of the risk-based requirements, the costs of performing the proposed procedures are unlikely to be disproportionate to the benefits of the proposed procedures.

*Question:*

14. 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?

**VII. Effective Date**

The Board seeks comment on the amount of time auditors would need after adoption of the proposed amendments and new auditing standard, and approval by the SEC, before they become effective.

*Question:*

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

**VIII. List of Appendices**

The Board's proposal includes this release and the following appendices:

- Appendix 1 contains the text of proposed amendments to AS 2101, 1201, 1215, and 1220;

- Appendix 2 contains the text of the proposed new standard for situations in which the auditor divides responsibility for the audit with another accounting firm;
- Appendix 3 contains the text of other related proposed amendments to PCAOB auditing standards and rules;
- Appendix 4 details certain aspects of the proposed amendments and proposed new standard, including significant differences with the analogous standards of the IAASB and the ASB, and provides additional questions for commenters; and
- Appendix 5 describes certain characteristics of self-identified EGCs.

**IX. Opportunity for Public Comment**

The Board is seeking comments on all aspects of its proposal, as well as specific comments on the proposed amendments and proposed new standard. Among other things, the Board is seeking comment on the economic analysis relating to its proposal, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data regarding the proposed amendments and standard.

Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. Comments also may be submitted by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's website at [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to PCAOB Rulemaking Docket Matter No. 042 in the subject or reference line and should be received by the Board no later than July 29, 2016.

The Board will consider all comments received. After the close of the comment period, the Board will determine whether to adopt final rules, with or without changes from the proposal. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of Sarbanes-Oxley, proposed rules of the Board do not take effect unless approved by the SEC. Standards are rules of the Board under Sarbanes-Oxley.

On the 12<sup>th</sup> day of April, in the year 2016, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown  
Secretary

April 12, 2016

## **APPENDIX 1**

### **Proposed Amendments Relating to the Performance of Audits Involving Other Auditors**

This appendix proposes amendments to AS 2101 (currently Auditing Standard No. 9), *Audit Planning*, AS 1201 (currently Auditing Standard No. 10), *Supervision of the Audit Engagement*, AS 1215 (currently Auditing Standard No. 3), *Audit Documentation*, and AS 1220 (currently Auditing Standard No. 7), *Engagement Quality Review*. Language that would be deleted by the proposed amendments is ~~struck through~~. Language that would be added is underlined. The presentation of the proposed amendments by showing deletions and additions to existing sentences, paragraphs, and footnotes is intended to assist readers in comprehending the Board's proposed changes to the auditing standard. The Board's proposed amendments consist of only the deleted or added language. This presentation does not constitute or represent a reproposal of all or of any other part of the auditing standard, as amended by this proposal.<sup>1</sup>

#### **Auditing Standards Affected**

<b>PCAOB Standard</b>	<b>Para- graph or Appendix</b>	<b>Subject Heading of Paragraph(s) Affected</b>	<b>Action</b>	<b>Page</b>
<b>Planning an Audit</b>				
AS 2101 (currently Auditing Standard No. 9), <i>Audit Planning</i>	.04	Planning an Audit	Add AS 2101.04A	p. A1–4
AS 2101	.09	Planning an Audit: Audit Strategy	Make conforming amendment	p. A1–7
AS 2101	.14	Planning an Audit: Multi-location Engagements	Make conforming amendment	p. A1–10
AS 2101	.16	Persons with Specialized Skill or	Make conforming amendment	p. A1–11

<sup>1</sup> Parenthetical citations to current auditing standards of the PCAOB are provided for reference purposes and would not appear in the final amendments.

PCAOB Standard	Para-graph or Appendix	Subject Heading of Paragraph(s) Affected	Action	Page
		Knowledge		
AS 2101	Appendix A	Definitions	Add AS 2101.A3–.A6	p. A1–12
AS 2101	Appendix B	Additional Requirements for the Lead Auditor When Planning an Audit That Involves Other Auditors or Referred-to Auditors	Add	p. A1–14
<b>Supervision of the Audit Engagement</b>				
AS 1201 (currently Auditing Standard No. 10), <i>Supervision of the Audit Engagement</i>	.03	Responsibility of the Engagement Partner for Supervision	Amend	p. A1–17
AS 1201	Appendix A	Definitions	Add AS 1201.A3–.A5	p. A1–20
AS 1201	Appendix B	Procedures to Be Performed by the Lead Auditor with Respect to the Supervision of the Other Auditors' Work	Add	p. A1–22
<b>Engagement Quality Review</b>				
AS 1220 (currently Auditing Standard No. 7), <i>Engagement Quality Review</i>	.10a	Engagement Quality Review for an Audit: Engagement Quality Review Process	Amend	p. A1–25

PCAOB Standard	Para-graph or Appendix	Subject Heading of Paragraph(s) Affected	Action	Page
<b>Audit Documentation</b>				
AS 1215 (currently Auditing Standard No. 3), <i>Audit Documentation</i>	.18, .19	Retention of and Subsequent Changes to Audit Documentation	Make conforming amendment: AS 1215.18, .19 Add AS 1215.19A	p. A1–26

### **Auditing Standard and Interpretation Superseded**

Auditing Standard or Interpretation
AS 1205 (currently AU sec. 543), <i>Part of the Audit Performed by Other Independent Auditors</i>
AI 10, <i>Part of the Audit Performed by Other Independent Auditors: Auditing Interpretations of AS 1205</i> (currently AU sec. 9543, <i>Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543</i> )

### **AS 2101 (currently Auditing Standard No. 9), *Audit Planning***

#### ***Introduction***

.01 This standard establishes requirements regarding planning an audit.

#### ***Objective***

.02 The objective of the auditor is to plan the audit so that the audit is conducted effectively.

#### ***Responsibility of the Engagement Partner for Planning***

.03 The **engagement partner**<sup>1</sup> is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for planning the audit and may seek assistance from appropriate **engagement team** members in fulfilling this

responsibility. Engagement team members who assist the engagement partner with audit planning also should comply with the relevant requirements in this standard.

<sup>1</sup> Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

### ***Planning an Audit***

.04 The auditor should properly plan the audit. This standard describes the auditor's responsibilities for properly planning the audit.<sup>2</sup>

.04A For audits that involve **other auditors** or **referred-to auditors**, Appendix B describes additional requirements for the **lead auditor** regarding planning an audit.

<sup>2</sup> The term, "auditor," as used in this standard, encompasses both the engagement partner and the engagement team members who assist the engagement partner in planning the audit.

.05 Planning the audit includes establishing the overall audit strategy for the engagement and developing an audit plan, which includes, in particular, planned risk assessment procedures and planned responses to the risks of material misstatement. Planning is not a discrete phase of an audit but, rather, a continual and iterative process that might begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit.

### **Preliminary Engagement Activities**

.06 The auditor should perform the following activities at the beginning of the audit:

- a. Perform procedures regarding the continuance of the client relationship and the specific audit engagement,<sup>3</sup>
- b. Determine compliance with independence and ethics requirements, and

Note: The determination of compliance with independence and ethics requirements is not limited to preliminary engagement activities and should be reevaluated with changes in circumstances.

- c. Establish an understanding of the terms of the audit engagement with the audit committee in accordance with AS 1301 (currently Auditing Standard No. 16), *Communications with Audit Committees*.

<sup>3</sup> Paragraphs .14–.16 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. AS 1110, *Relationship of Auditing Standards to Quality Control Standards* (currently AU sec. 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards*), explains how the quality control standards relate to the conduct of audits.

### **Planning Activities**

.07 The nature and extent of planning activities that are necessary depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit. When developing the audit strategy and audit plan, as discussed in paragraphs .08–.10, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality,<sup>5</sup> risk, and, in integrated audits, other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee<sup>6</sup> or management;

- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and
- The relative complexity of the company's operations.

Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

<sup>5</sup> AS 2105, *Consideration of Materiality in Planning and Performing an Audit*.

<sup>6</sup> If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

### **Audit Strategy**

.08 The auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan.

- .09 In establishing the overall audit strategy, the auditor should take into account:
- a. The reporting objectives of the engagement and the nature of the communications required by PCAOB standards,<sup>7</sup>
  - b. The factors that are significant in directing the activities of the engagement team,<sup>8</sup>
  - c. The results of preliminary engagement activities<sup>9</sup> and the auditor's evaluation of the important matters in accordance with paragraph .07 of this standard, and
  - d. The nature, timing, and extent of resources necessary to perform the engagement.<sup>10</sup>

<sup>7</sup> See, e.g., AS 1301. Also, various laws or regulations require other matters to be communicated. (See, e.g., Rule 2-07 of Regulation S-X, 17 CFR 210.2-07; and Rule 10A-3 under the Securities Exchange Act of 1934, 17 CFR 240.10A-3.) The requirements of this standard do not modify communications required by those other laws or regulations.

<sup>8</sup> See, e.g., paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*, and paragraph .06 of AS 1201, *Supervision of the Audit Engagement*. See also, Appendix B of AS 1201, which describes further procedures to be performed by the lead auditor with respect to the supervision of the other auditors' work, in conjunction with the required supervisory activities set forth in AS 1201.

<sup>9</sup> Paragraph .06 of this standard.

<sup>10</sup> See, e.g., ~~paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*~~AS 1015.06, paragraph .16 of this standard, and paragraph .05a. of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

## **Audit Plan**

.10 The auditor should develop and document an audit plan that includes a description of:

- a. The planned nature, timing, and extent of the risk assessment procedures;<sup>11</sup>

- b. The planned nature, timing, and extent of tests of controls and substantive procedures;<sup>12</sup> and
- c. Other planned audit procedures required to be performed so that the engagement complies with PCAOB standards.

<sup>11</sup> AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

<sup>12</sup> AS 2301 and AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

### **Multi-location Engagements**

.11 In an audit of the financial statements of a company with operations in multiple locations or business units,<sup>13</sup> the auditor should determine the extent to which audit procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.

<sup>13</sup> The term "business units" includes subsidiaries, divisions, branches, components, or investments.

.12 Factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures include:

- a. The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, *e.g.*, 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 ("significant unusual transactions") executed at the location or business unit;<sup>14</sup>

- b. The materiality of the location or business unit;<sup>15</sup>
- c. The specific risks associated with the location or business unit that present a reasonable possibility<sup>16</sup> of material misstatement to the company's consolidated financial statements;
- d. Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;
- e. The degree of centralization of records or information processing;
- f. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and
- g. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.

Note: When performing an audit of internal control over financial reporting, refer to Appendix B, Special Topics, of AS 2201<sup>17</sup> for considerations when a company has multiple locations or business units.

<sup>14</sup> Paragraph .66 of AS 2401 (currently AU sec. 316), *Consideration of Fraud in a Financial Statement Audit*.

<sup>15</sup> AS 2105.10 describes the consideration of materiality in planning and performing audit procedures at an individual location or business unit.

<sup>16</sup> There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

<sup>17</sup> AS 2201.B10–.B16.

.13 In determining the locations or business units at which to perform audit procedures, the auditor may take into account relevant activities performed by internal audit, as described in AS 2605, *Consideration of the Internal Audit Function*, or others, as described in AS 2201. AS 2605 and AS 2201 establish requirements regarding using the work of internal audit and others, respectively.

~~.14 AS 1205, *Part of the Audit Performed by Other Independent Auditors*, describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more of the locations or business units that are included in the consolidated financial statements.<sup>48</sup> In an audit that involves other auditors or referred-to auditors those situations, the lead auditor should perform the procedures in paragraphs .11–.13 of this standard to determine the locations or business units at which audit procedures should be performed. In making this determination, the lead auditor should hold discussions with and obtain information from the other auditors<sup>18A</sup> or referred-to auditors, as necessary, to identify and assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit.~~

Note: AS 1201 sets forth specific procedures for the lead auditor to perform in determining the audit procedures to be performed by other auditors. AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, sets forth the lead auditor's responsibilities for dividing responsibility for the audit of the company's financial statements and, if applicable, internal control over financial reporting with a referred-to auditor.

~~<sup>48</sup> For integrated audits, see also AS 2201.C8–.C11.~~

<sup>18A</sup> AS 2110.49–.53 describe conducting a discussion among engagement team members regarding risks of material misstatement.

### **Changes During the Course of the Audit**

.15 The auditor should modify the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit, including changes due to a revised assessment of the risks of material misstatement or the discovery of a previously unidentified risk of material misstatement.

### **Persons with Specialized Skill or Knowledge**

.16 The auditor should determine whether specialized skill or knowledge, including relevant knowledge of foreign jurisdictions, is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

.17 If a person with specialized skill or knowledge employed or engaged by the auditor participates in the audit, the auditor should have sufficient knowledge of the subject matter to be addressed by such a person to enable the auditor to:

- a. Communicate the objectives of that person's work;
- b. Determine whether that person's procedures meet the auditor's objectives; and
- c. Evaluate the results of that person's procedures as they relate to the nature, timing, and extent of other planned audit procedures and the effects on the auditor's report.

### ***Additional Considerations in Initial Audits***

.18 The auditor should undertake the following activities before starting an initial audit:

- a. Perform procedures regarding the acceptance of the client relationship and the specific audit engagement; and
- b. Communicate with the predecessor auditor in situations in which there has been a change of auditors in accordance with AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors*.

.19 The purpose and objective of planning the audit are the same for an initial audit or a recurring audit engagement. However, for an initial audit, the auditor should determine the additional planning activities necessary to establish an appropriate audit strategy and audit plan, including determining the audit procedures necessary to obtain sufficient appropriate audit evidence regarding the opening balances.<sup>19</sup>

<sup>19</sup> See also paragraph .03 of AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements*.

## Appendix A – Definitions

.A1 For purposes of this standard, the terms listed below ~~is~~are defined as follows:

.A2 Engagement partner – The member of the engagement team with primary responsibility for the audit.

.A3 Engagement team –

a. Engagement team includes:

- (1) Partners, principals, and shareholders of, and accountants<sup>20</sup> and other professional staff employed or engaged by, the lead auditor or other accounting firms, who perform audit procedures on an audit or assist the engagement partner in fulfilling his or her planning or supervisory responsibilities on the audit pursuant to AS 2101 or AS 1201; and
- (2) Specialists whose work is used on the audit and who are employed by the lead auditor or another accounting firm participating in the audit.

b. Engagement team does not include:

- (1) The engagement quality reviewer and those assisting the reviewer (to which AS 1220 (currently Auditing Standard No. 7), *Engagement Quality Review*, applies);
- (2) Partners, principals, and shareholders of, and other individuals employed or engaged by, another accounting firm in situations in which the lead auditor divides responsibility for the audit with the other firm under AS 1206; or
- (3) Engaged specialists.<sup>21</sup>

<sup>20</sup> See paragraph (a)(ii) in PCAOB Rule 1001, *Definitions of Terms Employed in Rules*.

<sup>21</sup> See AS 1210.

.A4 Lead auditor –

- a. The registered public accounting firm<sup>22</sup> 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.<sup>23</sup>

Note: The registered public accounting firm issuing the auditor's report is also referred to in this standard as "the engagement partner's firm."

<sup>22</sup> See paragraph (r)(i) in PCAOB Rule 1001, *Definitions of Terms Employed in Rules*, which defines the term "registered public accounting firm."

<sup>23</sup> See AS 2301.05a, which describes making appropriate assignments of significant engagement responsibilities. See also AS 1015.06, according to which "[a]uditors should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability."

.A5 Other auditor –

- a. A member of the engagement team who is not a partner, principal, shareholder, or employee of the lead auditor; and
- b. A public accounting firm, if any, of which such engagement team member is a partner, principal, shareholder, or employee.

.A6 Referred-to auditor – A public accounting firm, other than the lead auditor, that performs an audit of the financial statements and, if applicable, internal control over financial reporting of one or more of the company's business units<sup>24</sup> and issues an auditor's report in accordance with the standards of the PCAOB to which the lead auditor makes reference in the lead auditor's report on the company's financial statements and, if applicable, internal control over financial reporting.

<sup>24</sup> The term "business units" includes subsidiaries, divisions, branches, components, or investments.

## **Appendix B – Additional Requirements for the Lead Auditor When Planning an Audit that Involves Other Auditors or Referred-to Auditors**

.B1 For engagements that involve other auditors or referred-to auditors, this appendix describes additional procedures to be performed by the lead auditor with respect to planning the audit.

Note: The lead auditor must supervise, in accordance with AS 1201,<sup>25</sup> the work of other auditors. When the responsibility for the audit is divided with another accounting firm (i.e., a referred-to auditor), AS 1206 applies.<sup>26</sup>

<sup>25</sup> AS 1201 establishes requirements regarding supervision of the audit engagement, including supervising the work of engagement team members.

<sup>26</sup> AS 1206 establishes requirements for the lead auditor regarding dividing responsibility for the audit of the company's financial statements and, if applicable, internal control over financial reporting with another accounting firm that performs an audit of the financial statements and, if applicable, internal control over financial reporting of one or more of the company's business units and issues an auditor's report in accordance with the standards of the PCAOB.

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

.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.

.B3 In an integrated audit of financial statements and internal control over financial reporting, the lead auditor of the financial statements must participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the lead

auditor of internal control over financial reporting. Only the lead auditor of the financial statements can be the lead auditor of internal control over financial reporting.

### **Other Auditors' Compliance with Independence and Ethics**

B4. In an audit that involves other auditors,<sup>27</sup> 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.

Note: The lead auditor's determination of each other auditor's compliance with the SEC and PCAOB independence and ethics requirements is not limited to preliminary engagement activities and should be reevaluated with changes in circumstances.

Note: If the lead auditor becomes aware of information during the course of the audit that contradicts a representation made by an other auditor regarding its compliance with the SEC and PCAOB independence and ethics requirements, the lead auditor should perform additional procedures to determine the effect of the information on the independence of the other auditor.

<sup>27</sup> See AS 1206 for requirements for the lead auditor relating to the referred-to auditor's compliance with the SEC and PCAOB independence and ethics requirements.

### **Registration Status of Other Auditors**

.B5 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.<sup>28</sup>

<sup>28</sup> See PCAOB Rule 2100, *Registration Requirements for Public Accounting Firms*, and paragraph (p)(ii) in PCAOB Rule 1001, *Definitions of Terms Employed in Rules*, which defines the phrase "play a substantial role in the preparation or furnishing of an audit report." See also AS 1206 for requirements for the lead auditor relating to the registration status of the referred-to auditor.

### **Qualifications of and Communication with Other Auditors**

.B6 At the beginning of an audit that involves other auditors, the lead auditor should:

a. Gain an understanding of the knowledge, skill, and ability of the other auditors who assist the lead auditor with planning or supervision,<sup>29</sup> including their:

(1) Experience in the industry in which the company operates; and

(2) Knowledge of the relevant financial reporting framework, PCAOB standards and rules, and SEC rules and regulations, and their experience in applying the standards, rules, and regulations; and

b. Determine that it is able to communicate with the other auditors and gain access to their work papers.<sup>30</sup>

Note: The requirements of this paragraph are not limited to preliminary engagement activities and should be reevaluated with changes in circumstances.

<sup>29</sup> See AS 1015.06, according to which "[a]uditors should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability", and AS 2301.05a, which describes making appropriate assignments of significant engagement responsibilities. See also AS 1201.B3, which describes assisting the lead auditor with supervision in a multi-tiered engagement team.

<sup>30</sup> See, e.g., AS 1201.05, and Appendix B of AS 1201, which establish requirements for the auditor's review of work performed by engagement team members. See also AS 1215.18, according to which audit documentation supporting the work performed by other auditors must be retained by or be accessible to the office of the firm issuing the auditor's report.

## **AS 1201 (currently Auditing Standard No. 10), *Supervision of the Audit Engagement***

### ***Introduction***

.01 This standard establishes requirements regarding supervision of the audit engagement, including supervising the work of **engagement team**<sup>1</sup> members.

<sup>1</sup> Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

### ***Objective***

.02 The objective of the auditor is to supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

### ***Responsibility of the Engagement Partner for Supervision***

.03 The **engagement partner**<sup>4</sup> is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the work of engagement team members (including engagement team members outside the engagement partner's firm). The engagement partner also is responsible ~~and~~ for compliance with PCAOB standards, including standards regarding: using the work of specialists,<sup>2</sup> ~~other auditors,~~<sup>3</sup> internal auditors,<sup>4</sup> and others who are involved in testing controls;<sup>5</sup> and dividing responsibility with another accounting firm.<sup>5A</sup> Paragraphs .05–.06 of this standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.<sup>6</sup>

Note: Appendix B describes further procedures to be performed by the **lead auditor** with respect to the supervision of the work of **other auditors** in conjunction with the required supervisory activities set forth below.

<sup>2</sup> AS 1210 (currently AU sec. 336), *Using the Work of a Specialist*.

<sup>3</sup> ~~AS 1205, *Part of the Audit Performed by Other Independent Auditors*.~~

<sup>4</sup> AS 2605, *Consideration of the Internal Audit Function* (currently AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of the Financial Statements*).

<sup>5</sup> Paragraphs .16–.19 of AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

<sup>5A</sup> See AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*.

<sup>6</sup> See also paragraph .06 of AS 1015 (currently AU sec. 230), *Due Professional Care in the Performance of Work*.

.04 The engagement partner may seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to this standard. Engagement team members who assist the engagement partner with supervision of the work of other engagement team members also should comply with the requirements in this standard with respect to the supervisory responsibilities assigned to them.

### ***Supervision of Engagement Team Members***

.05 The engagement partner and, as applicable, other engagement team members performing supervisory activities, should:

- a. Inform engagement team members of their responsibilities,<sup>7</sup> including:
  - (1) The objectives of the procedures that they are to perform;
  - (2) The nature, timing, and extent of procedures they are to perform; and
  - (3) Matters that could affect the procedures to be performed or the evaluation of the results of those procedures, including relevant aspects of the company, its environment, and its internal control over financial reporting,<sup>8</sup> and possible accounting and auditing issues;
- b. Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement

partner or other engagement team members performing supervisory activities so they can evaluate those issues and determine that appropriate actions are taken in accordance with PCAOB standards;<sup>9</sup>

Note: In applying due professional care in accordance with AS 1015, each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or the auditor's report regardless of how those disagreements or concerns may have arisen.

- c. Review the work of engagement team members to evaluate whether:
- (1) The work was performed and documented;
  - (2) The objectives of the procedures were achieved; and
  - (3) The results of the work support the conclusions reached.<sup>10</sup>

<sup>7</sup> AS 1015.06 and paragraph .05 of AS 2301 (currently Auditing Standard No. 13), *The Auditor's Responses to the Risks of Material Misstatement*, establish requirements regarding the appropriate assignment of engagement team members.

<sup>8</sup> AS 2110 (currently Auditing Standard No. 12), *Identifying and Assessing Risks of Material Misstatement*, describes the auditor's responsibilities for obtaining an understanding of the company, its environment, and its internal control over financial reporting.

<sup>9</sup> See, e.g., paragraph .15 of AS 2101 (currently Auditing Standard No. 9), *Audit Planning*, AS 2110.74, and paragraphs .20–.23 and .35–.36 of AS 2810 (currently Auditing Standard No. 14), *Evaluating Audit Results*.

<sup>10</sup> AS 2810 describes the auditor's responsibilities for evaluating the results of the audit, and AS 1215 (currently Auditing Standard No. 3), *Audit Documentation*, establishes requirements regarding audit documentation.

.06 To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the

engagement partner and other engagement team members performing supervisory activities should take into account:

- a. The nature of the company, including its size and complexity;<sup>11</sup>
- b. The nature of the assigned work for each engagement team member, including:
  - (1) The procedures to be performed, and
  - (2) The controls or accounts and disclosures to be tested;
- c. The risks of material misstatement; and
- d. The knowledge, skill, and ability of each engagement team member.<sup>12</sup>

Note: In accordance with the requirements of AS 2301.05 the extent of supervision of engagement team members should be commensurate with the risks of material misstatement.<sup>13</sup>

<sup>11</sup> AS 2110.10.

<sup>12</sup> See *also* AS 2301.05a and AS 1015.06.

<sup>13</sup> AS 2301.05b indicates that the extent of supervision of engagement team members is part of the auditor's overall responses to the risks of material misstatement.

## **Appendix A – Definitions**

.A1 For purposes of this standard, the terms listed below ~~is~~are defined as follows:

.A2 Engagement partner – The member of the engagement team with primary responsibility for the audit.

.A3 Engagement team –

a. Engagement team includes:

(1) Partners, principals, and shareholders of, and accountants<sup>14</sup> and other professional staff employed or engaged by, the lead auditor or other accounting firms, who perform audit procedures on an audit or assist the engagement partner in fulfilling his or her planning or supervisory responsibilities on the audit pursuant to AS 2101 or AS 1201; and

(2) Specialists whose work is used on the audit and who are employed by the lead auditor or another accounting firm participating in the audit.

b. Engagement team does not include:

(1) The engagement quality reviewer and those assisting the reviewer (to which AS 1220 (currently Auditing Standard No. 7), *Engagement Quality Review*, applies);

(2) Partners, principals, and shareholders of, and other individuals employed or engaged by, another accounting firm in situations in which the lead auditor divides responsibility for the audit with the other firm under AS 1206; or

(3) Engaged specialists.<sup>15</sup>

<sup>14</sup> See paragraph (a)(ii) in PCAOB Rule 1001, *Definitions of Terms Employed in Rules*.

<sup>15</sup> See AS 1210.

.A4 Lead auditor –

a. The registered public accounting firm<sup>16</sup> 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.<sup>17</sup>

Note: The registered public accounting firm issuing the auditor's report is also referred to in this standard as "the engagement partner's firm."

<sup>16</sup> See paragraph (r)(i) in PCAOB Rule 1001, *Definitions of Terms Employed in Rules*, which defines the term "registered public accounting firm."

<sup>17</sup> See AS 2301.05a, which describes making appropriate assignments of significant engagement responsibilities. See also AS 1015.06, according to which "[a]uditors should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability."

.A5 Other auditor –

- a. A member of the engagement team who is not a partner, principal, shareholder, or employee of the lead auditor; and
- b. A public accounting firm, if any, of which such engagement team member is a partner, principal, shareholder, or employee.

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

.B1 For engagements that involve other auditors, this appendix describes procedures to be performed by the lead auditor with respect to the supervision of the other auditors' work, in conjunction with the required supervisory activities set forth in this standard. The requirements of this appendix supplement the requirements in paragraph .05 of this standard. In performing the procedures described in this appendix the lead auditor should determine the extent of supervision of the other auditors' work in accordance with paragraph .06 of this standard.

Note: The lead auditor should hold discussions with and obtain information from the other auditors, as necessary for the performance of procedures described in this appendix.

.B2 In supervising the work of other auditors, the lead auditor should:<sup>18</sup>

- a. Inform the other auditor of the following in writing:
  - (1) The scope of work to be performed by the other auditor; and

(2) Tolerable misstatement,<sup>19</sup> the identified risks of material misstatement,<sup>20</sup> and, if determined, the amount below which misstatements are clearly trivial and do not need to be accumulated<sup>21</sup> relevant to the work requested to be performed.

b. Obtain and review the other auditor's description of the nature, timing, and extent of audit procedures to be performed pursuant to the scope of work described in paragraph .B2a.(1), determine whether any changes to the procedures are necessary, discuss such changes with the other auditor, and communicate them in writing to the other auditor;

Note: Based on the necessary extent of supervision of the other auditor's work by the lead auditor, it may be necessary for the lead auditor (rather than the other auditor) to determine the nature, timing, and extent of procedures to be performed.

c. Direct the other auditor to provide for review specified documentation with respect to the work requested to be performed;<sup>22</sup>

d. Obtain from the other auditor a written report describing the other auditor's procedures, findings, conclusions, and, if applicable, opinion;

e. Determine, based on a review of the documentation and written report provided by the other auditor (pursuant to paragraphs .B2c and .B2d of this appendix), discussions with the other auditor, and other information obtained during the audit:

(1) Whether the other auditor complied with the written communications received pursuant to paragraphs .B2a and .B2b; and

(2) Whether additional audit evidence should be obtained with respect to the work performed by the other auditor, for example, to address a previously unidentified risk of material misstatement or in a situation in which sufficient appropriate audit evidence has not been obtained about a relevant assertion.<sup>23</sup>

<sup>18</sup> Paragraph .B3 of this appendix describes how the requirements of this paragraph can be applied in multi-tiered engagement teams.

<sup>19</sup> See paragraphs .08–.10 of AS 2105 (currently Auditing Standard No. 11), *Consideration of Materiality in Planning and Performing an Audit*.

<sup>20</sup> See requirements in AS 2110.49–.51 with respect to discussions among engagement team members in differing locations regarding risks of material misstatement.

<sup>21</sup> See AS 2810.10–.11.

<sup>22</sup> The specified documentation includes, but is not limited to, the documentation described in AS 1215.19.

<sup>23</sup> See AS 2810.35–.36.

.B3 In some audits, the engagement team may be organized in a multi-tiered structure. For example, an other auditor might audit the financial information of a location or business unit that includes the financial information of a sub-location or sub-unit audited by a second other auditor. As another example, an other auditor might assist the lead auditor in supervising a second other auditor.<sup>24</sup> In these situations, the lead auditor may direct the first other auditor to perform the procedures in paragraphs .B2b through .B2e with respect to the second other auditor on behalf of the lead auditor, if appropriate pursuant to the factors in paragraph .06. The lead auditor, in supervising the first other auditor, should evaluate the first other auditor's supervision of the second other auditor's work. The lead auditor remains responsible for informing directly both the first other auditor and second other auditor of the matters in paragraph .B2a.

<sup>24</sup> The requirements of this paragraph also apply to audits in which there are multiple second other auditors.

\* \* \*

## **AS 1220 (currently Auditing Standard No. 7), *Engagement Quality Review***

\* \* \*

### ***Engagement Quality Review for an Audit***

#### **Engagement Quality Review Process**

.09 In an audit engagement, the engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should, to the extent necessary to satisfy the requirements of paragraphs .10 and .11: (1) hold discussions with the engagement partner and other members of the engagement team, and (2) review documentation.

.10 In an audit, the engagement quality reviewer should:

- a. Evaluate the significant judgments that relate to engagement planning, including—
  - The consideration of the firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process,
  - The consideration of the company's business, recent significant activities, and related financial reporting issues and risks, ~~and~~
  - The judgments made about materiality and the effect of those judgments on the engagement strategy, and
  - In an audit involving other auditors or referred-to auditors, the engagement partner's determination that 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 and, if applicable, internal control over financial reporting.<sup>3A</sup>

<sup>3A</sup> The terms "lead auditor," "other auditors," and "referred-to auditor" have the same meaning as in Appendix A of AS 2101, *Audit Planning*. AS 2101.B2 and .B3 describe requirements for the engagement partner's determination that the participation of his or her firm is sufficient for it to serve as the lead auditor.

\* \* \*

### **AS 1215 (currently Auditing Standard No. 3), *Audit Documentation***

\* \* \*

#### **Retention of and Subsequent Changes to Audit Documentation**

\* \* \*

.18 The office of the firm issuing the auditor's report is responsible for ensuring that all audit documentation sufficient to meet the requirements of paragraphs .04–.13 of this standard is prepared and retained. Audit documentation supporting the work performed by other offices of the firm and other auditors<sup>3A</sup> ~~(including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms),~~ must be retained by or be accessible to the office issuing the auditor's report.<sup>4</sup>

<sup>3A</sup> The term "other auditors," as used in this standard, has the same meaning as in Appendix A of AS 1201.

<sup>4</sup> Section 106(b) of the Sarbanes-Oxley Act of 2002 imposes certain requirements concerning production of the work papers of a foreign public accounting firm and other related documents in certain circumstances ~~on whose opinion or services the auditor relies.~~ Compliance with this standard does not substitute for compliance with Section 106(b) or any other applicable law.

.19 In addition, 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 ~~(including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms):~~

- a. An engagement completion document consistent with paragraphs .12 and .13.

Note: This engagement completion document should include all cross-referenced, supporting audit documentation.

- b. A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.
- c. Sufficient information relating to any significant findings or issues that are inconsistent with or contradict the final conclusions, as described in paragraph .08.
- d. Any findings affecting the consolidating or combining of accounts in the consolidated financial statements.
- e. Sufficient information to enable the office issuing the auditor's report to agree or to reconcile the financial statement amounts audited by other offices of the firm and~~the~~ other auditors to the information underlying the consolidated financial statements.
- f. A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.
- g. All significant deficiencies and material weaknesses in internal control over financial reporting, including a clear distinction between those two categories.
- h. Letters of representations from management.
- i. All matters to be communicated to the audit committee.

~~If the auditor decides to make reference in his or her report to the audit of the other auditor, however, the auditor issuing the report need not perform the procedures in this paragraph and, instead, should refer to AS 1205, *Part of the Audit Performed by Other Independent Auditors*.~~

.19A Audit documentation of the office issuing the auditor's report must contain a list of additional work papers of other auditors (beyond those described in paragraph .19) that were reviewed by the lead auditor<sup>4A</sup> but not retained by the lead auditor, if any. The list

must include a description of the work papers reviewed, the reviewer, and the date of such review.

Note: According to paragraph .18, audit documentation supporting the work performed by other auditors must be retained by or be accessible to the office issuing the auditor's report.

<sup>4A</sup> The term "lead auditor," as used in this paragraph, has the same meaning as in Appendix A of AS 1201.

## **APPENDIX 2**

### **Proposed AS 1206: Dividing Responsibility for the Audit with Another Accounting Firm<sup>1</sup>**

#### **Introduction**

.01 This standard establishes requirements for the **lead auditor**<sup>2</sup> regarding dividing responsibility for the audit of the company's financial statements<sup>3</sup> and, if applicable, internal control over financial reporting with a **referred-to auditor**.<sup>4</sup>

Note: AS 2101 (currently Auditing Standard No. 9), *Audit Planning*, establishes requirements regarding serving as the lead auditor.<sup>5</sup>

Note: This standard applies when the lead auditor divides responsibility for the audit with one or more referred-to auditors. When there is more than one referred-to auditor, the lead auditor must apply the requirements of paragraphs .03 through .09 of this standard in relation to each of the referred-to auditors individually.

Note: When another accounting firm participates in the audit and the lead auditor does not divide responsibility for the audit with the other firm, AS 1201, *Supervision of the Audit Engagement*, establishes requirements regarding the

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<sup>1</sup> Parenthetical citations to current auditing standards of the PCAOB are provided for reference purposes and would not appear in the final standard.

<sup>2</sup> Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

<sup>3</sup> The term "company's financial statements," as used in this standard, describes the financial statements of a company that include—through consolidation or combination—the financial statements of the company's business units.

<sup>4</sup> For integrated audits, see also paragraphs .C8 through .C11 of AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

<sup>5</sup> See paragraphs .B2 and .B3 of AS 2101.

supervision of the work of the engagement team members, including those not employed by the lead auditor.<sup>6</sup>

## **Objectives**

.02 The objectives of the lead auditor are to: (1) communicate with the referred-to auditor and determine that audit procedures are properly performed with respect to the consolidation or combination of accounts in the company's financial statements and (2) make the necessary disclosures in the lead auditor's report.

## **Performing Procedures with Respect to the Audit of the Referred-to Auditor**

.03 The lead auditor should determine that audit procedures are performed, in coordination with the referred-to auditor, to test and evaluate the consolidation or combination of the financial statements of the business units<sup>7</sup> audited by the referred-to auditor into the company's financial statements.<sup>8</sup> Matters affecting such consolidation or combination include, for example, intercompany transactions.

.04 The lead auditor should communicate to the referred-to auditor, in writing, the lead auditor's plan to divide responsibility for the audit with the referred-to auditor pursuant to this standard and other applicable PCAOB standards.

.05 The lead auditor should request a written representation from the referred-to auditor that the referred-to auditor is:

- a. In compliance with the independence and ethics requirements of the PCAOB and the U.S. Securities and Exchange Commission ("SEC"); and
- b. Duly licensed to practice under the laws of the jurisdiction that apply to the work of the referred-to auditor.

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<sup>6</sup> The term "engagement team," as used in this standard, has the same meaning as in Appendix A of AS 2101.

<sup>7</sup> The term "business units" includes subsidiaries, divisions, branches, components, or investments.

<sup>8</sup> See paragraphs .30 and .31 of AS 2810, *Evaluating Audit Results*.

.06 The lead auditor may divide responsibility for the audit with another accounting firm only if:

- a. The referred-to auditor has represented that it has performed an audit and issued an auditor's report in accordance with the standards of the PCAOB;<sup>9</sup>
- 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;
- c. The lead auditor determines, based on inquiries made to the referred-to auditor and other information obtained by the lead auditor during the audit, that the referred-to auditor knows the relevant requirements of the applicable financial reporting framework, standards of the PCAOB, and financial reporting requirements of the SEC;
- d. The representation from the referred-to auditor described in paragraph .05 and other information obtained by the lead auditor during the audit indicates that:
  - (1) The referred-to auditor is in compliance with the independence and ethics requirements of the PCAOB and the SEC; and
  - (2) The referred-to auditor is duly licensed to practice under the laws of the jurisdiction that apply to the work of the referred-to auditor; and
- e. The referred-to auditor that would play a substantial role in the preparation or furnishing of the lead auditor's report on the company's financial

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<sup>9</sup> AS 3101, *Reports on Audited Financial Statements*, applies to auditors' reports issued in connection with audits of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with the applicable financial reporting framework. AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, applies to auditors' reports issued in connection with audits of management's assessment of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements.

statements and, if applicable, internal control over financial reporting, is registered pursuant to the rules of the PCAOB.<sup>10</sup>

.07 In situations in which the lead auditor is unable to divide responsibility with another accounting firm (e.g., due to concerns about the competence or independence of the referred-to auditor), the lead auditor should:

- a. Plan and perform procedures with respect to the relevant business unit that are necessary for the lead auditor to issue an opinion on the company's financial statements and, if applicable, internal control over financial reporting;
- b. Appropriately qualify or disclaim an opinion on the company's financial statements and, if applicable, internal control over financial reporting; or

Note: The lead auditor should state the reasons for modifying the report, and, when expressing a qualified opinion, disclose the magnitude of the portion of the company's financial statements to which the lead auditor's qualification extends.<sup>11</sup>

- c. Withdraw from the engagement.

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<sup>10</sup> See PCAOB Rule 2100, *Registration Requirements for Public Accounting Firms*, and paragraph (p)(ii) in PCAOB Rule 1001, *Definitions of Terms Employed in Rules*, which defines the phrase "play a substantial role in the preparation or furnishing of an audit report."

<sup>11</sup> If the lead auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude whether the financial statements are free of material misstatement, AS 3101 (currently AU sec. 508), *Reports on Audited Financial Statements*, indicates that the auditor should express a qualified opinion or a disclaimer of opinion. For integrated audits, AS 2201.74 states, "[t]he auditor may form an opinion on the effectiveness of internal control over financial reporting only when there have been no restrictions on the scope of the auditor's work. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement (see paragraphs .C3 through .C7)."

## **Making Reference in the Lead Auditor's Report**

.08 When the lead auditor divides responsibility for the audit with the referred-to auditor, the lead auditor's report must make reference to the audit and auditor's report of the referred-to auditor. The lead auditor's report should:

- a. Indicate clearly, in the introductory, scope, and opinion paragraphs, the division of responsibility between that portion of the company's financial statements, and if applicable, internal control over financial reporting, covered by the lead auditor's own audit and that covered by the audit of the referred-to auditor;
- b. Identify the referred-to auditor by name and refer to the auditor's report of the referred-to auditor when describing the scope of the audit and when expressing an opinion;<sup>12</sup> and
- c. 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. This may be done by stating the dollar amounts or percentages of total assets, total revenues, and other appropriate criteria necessary to identify the portion of the company's financial statements audited by the referred-to auditor.

Note: Appendix B includes 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.

Note: The lead auditor's decision regarding making reference to the audit and report of the referred-to auditor in the lead auditor's report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements.<sup>13</sup>

.09 If the report of the referred-to auditor is other than a standard report, the lead auditor should make reference to the departure from the standard report and its

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<sup>12</sup> Rule 2-05 of Regulation S-X, 17 C.F.R. 210.2-05, includes requirements regarding filing the referred-to auditor's report with the SEC.

<sup>13</sup> See, e.g., AS 2201.C10.

disposition in the lead auditor's report, unless the matter is clearly trivial to the company's financial statements.

## **APPENDIX A – Definitions**

- .A1 For purposes of this standard, the terms listed below are defined as follows:
- .A2 Lead auditor –
- a. The registered public accounting firm<sup>14</sup> 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.<sup>15</sup>
- .A3 Referred-to auditor – A public accounting firm, other than the lead auditor, that performs an audit of the financial statements and, if applicable, internal control over financial reporting of one or more of the company's business units<sup>16</sup> and issues an auditor's report in accordance with the standards of the PCAOB to which the lead auditor makes reference in the lead auditor's report on the company's financial statements and, if applicable, internal control over financial reporting.

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<sup>14</sup> See paragraph (r)(i) in PCAOB Rule 1001, *Definitions of Terms Employed in Rules*, which defines the term registered public accounting firm.

<sup>15</sup> See AS 2301.05a, which describes making appropriate assignments of significant engagement responsibilities. See also AS 1015.06, according to which "[a]uditors should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability."

<sup>16</sup> The term "business units" includes subsidiaries, divisions, branches, components, or investments.

## **APPENDIX B – 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**

.B1 The following is 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:

### Report of Independent Registered Public Accounting Firm<sup>17</sup>

*[Introductory paragraphs]*

We have audited the accompanying consolidated balance sheets of X Company and subsidiaries as of December 31, 20X3 and 20X2, and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X3. We also have audited X Company's internal control over financial reporting as of December 31, 20X3, based on [Identify control criteria, for example, "criteria established in *Internal Control—Integrated Framework: 2013 issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*"]. X Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying [title of management's report]. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

We did not audit the financial statements and internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets constituting XX percent and YY percent of consolidated assets as of December 31, 20X3 and 20X2, respectively, and total revenues constituting XX percent, YY percent, and ZZ percent of consolidated revenues for the years

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<sup>17</sup> Proposed Auditing Standards—The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards, PCAOB Release No. 2013-005, (Aug. 13, 2013) proposed a number of changes to the auditor's report.

ended December 31, 20X3, 20X2, and 20X1, respectively. Those financial statements and internal control over financial reporting were audited by Firm ABC whose report has been furnished to us, and our opinions, insofar as they relate to the amounts included for B Company and its internal control over financial reporting, are based solely on the report of Firm ABC.

*[Scope paragraph]*

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. We believe that our audits and the report of Firm ABC provide a reasonable basis for our opinions.

*[Definition paragraph]*

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

*[Inherent limitations paragraph]*

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

*[Opinion paragraph]*

In our opinion, based on our audits and the report of Firm ABC, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company and subsidiaries as of December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X3, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, based on our audits and the report of Firm ABC, X Company and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [Identify control criteria, for example, "criteria established in *Internal Control—Integrated Framework: 2013 issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*"].

*[Signature]*

*[City and State or Country]*

*[Date]*

## **APPENDIX 3**

### **Other Related Proposed Amendments to PCAOB Auditing Standards and Rules<sup>1</sup>**

In connection with the proposed amendments to AS 1201 (currently Auditing Standard No. 10), *Supervision of the Audit Engagement*; AS 1215 (currently Auditing Standard No. 3), *Audit Documentation*; AS 1220 (currently Auditing Standard No. 7), *Engagement Quality Review*; and AS 2101 (currently Auditing Standard No. 9), *Audit Planning*, the Board is proposing other related amendments, including conforming amendments, to several of its auditing standards and a rule ("other proposed amendments").<sup>2</sup> Some of the other proposed amendments relate to changes made to conform to the Board's proposed auditing standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm* (see Appendix 2 of this release).

Language that would be deleted by the other proposed amendments is ~~struck through~~. Language that would be added is underlined. The presentation of the other proposed amendments by showing deletions and additions to existing sentences, paragraphs and footnotes is intended to assist readers in easily comprehending the Board's proposed changes to auditing standards. The Board's other proposed amendments consist of only the deleted or added language. This presentation does not constitute or represent a reproposal of all or of any other part of a standard that may be amended.

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<sup>1</sup> Parenthetical citations to current auditing standards of the PCAOB are provided for reference purposes and would not appear in the final amendments.

<sup>2</sup> A number of the Board's pending rulemaking projects include proposals that would supersede, amend, or delete paragraphs of PCAOB auditing standards and auditing interpretations for which other proposed amendments are included in this appendix. These projects include PCAOB Release No. 2013-005, *Proposed Auditing Standards—The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report, and Related Amendments to PCAOB Standards* (Aug. 13, 2013). If, prior to the conclusion of this rulemaking, the Board adopts standards and related amendments that affect the other proposed amendments in this release, the Board may make conforming changes to these other proposed amendments.

This proposal would supersede AS 1205 (currently AU sec. 543), *Part of the Audit Performed by Other Independent Auditors*, and AI 10, *Part of the Audit Performed by Other Independent Auditors: Auditing Interpretations of AS 1205* (currently AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543*).

Certain provisions of AS 1205 are referenced in other PCAOB auditing standards. The other proposed amendments would incorporate these referenced provisions, modified as appropriate, directly into the text of the auditing standards that currently refer to them and would update other references to auditing standards and terminology to conform to requirements of the proposed amendments to AS 1201, AS 2101, and AS 1206.

The Board is requesting comments on all aspects of the proposed amendments.

### Auditing Standards and Rule Affected

PCAOB Standard or Rule	Paragraph, Section, or Appendix	Subject Heading of Paragraph(s) or Appendix Affected	Action	Page
AS 1301 (currently Auditing Standard No. 16), <i>Communications with Audit Committees</i>	.10	Obtaining Information and Communicating the Audit Strategy: Overall Audit Strategy, Timing of the Audit, and Significant Risks	Make conforming amendment	p. A3–7
AS 2110 (currently Auditing Standard No. 12), <i>Identifying and Assessing Risks of Material Misstatement</i>	.11A	Obtaining an Understanding of the Company and its Environment: Nature of the Company	Make conforming amendment	p. A3–9
AS 2201 (currently Auditing Standard No. 5), <i>An Audit of Internal Control Over Financial</i>	Appendix B	Special Topics: Use of Service Organizations	Make conforming amendment to AS 2201.B23	p. A3–10

PCAOB Standard or Rule	Paragraph, Section, or Appendix	Subject Heading of Paragraph(s) or Appendix Affected	Action	Page
<i>Reporting That Is Integrated with An Audit of Financial Statements</i>				
AS 2201	Appendix C	Special Reporting Situations: Report Modifications	Make conforming amendment to AS 2201.C1;  Amend AS2201.C8-.C11	p. A3-10
AS 2401 (currently AU sec. 316), <i>Consideration of Fraud in a Financial Statement Audit</i>	.53	Responding to Assessed Fraud Risks: Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed	Make conforming amendment	p. A3-13
AS 2401	.61	Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls	Make conforming amendment	p. A3-14
AS 2410 (currently Auditing Standard No. 18), <i>Related Parties</i>	.03	Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties	Make conforming amendment	p. A3-16
AS 2410	.09	Communicating with the Audit Engagement Team	Make conforming	p. A3-17

PCAOB Standard or Rule	Paragraph, Section, or Appendix	Subject Heading of Paragraph(s) or Appendix Affected	Action	Page
		and Other Auditors	amendment to subject heading; Amend AS 2410.09	
AS 2410	.16	Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties	Make conforming amendment	p. A3–18
AS 2503 (currently AU sec. 332), <i>Auditing Derivative Instruments, Hedging Activities, and Investments in Securities</i>	.28	Designing Substantive Procedures Based on Risks Assessments: Financial Statement Assertions: Valuation	Make conforming amendment	p. A3–20
AS 2601, <i>Consideration of an Entity's Use of a Service Organization</i> (currently AU sec. 324, <i>Service Organizations</i> )	.01	Introduction and Applicability	Make conforming amendment	p. A3–20
AS 2601	.18–.19	Considerations in Using a Service Auditor's Report	Make conforming amendment to AS 2601.18; Amend AS 2601.19	p. A3–21

<b>PCAOB Standard or Rule</b>	<b>Para- graph, Section, or Appendix</b>	<b>Subject Heading of Paragraph(s) or Appendix Affected</b>	<b>Action</b>	<b>Page</b>
AS 2605, <i>Consideration of the Internal Audit Function</i> (currently AU sec. 322, <i>The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements</i> )	.19	Extent of the Effect of the Internal Auditors' Work	Make conforming amendment	p. A3–22
AS 2610, <i>Initial Audits—Communications Between Predecessor and Successor Auditors</i> (currently AU sec. 315, <i>Communications Between Predecessor and Successor Auditors</i> )	.12	Successor Auditor's Use of Communications	Make conforming amendment	p. A3–23
AS 2610	.16	Audits of Financial Statements That Have Been Previously Audited	Make conforming amendment	p. A3–24
AS 2710 (currently AU sec. 550), <i>Other Information in Documents Containing Audited Financial Statements</i>	.04	-	Make conforming amendment	p. A3–24
AS 3101 (currently AU sec. 508), <i>Reports on Audited Financial Statements</i>	.11	Explanatory Language Added to the Auditor's Standard Report	Amend	p. A3–25

PCAOB Standard or Rule	Para- graph, Section, or Appendix	Subject Heading of Paragraph(s) or Appendix Affected	Action	Page
AS 3101	.12-.13	Opinion Based in Part on Report of Another Auditor	Amend	p. A3-27
AS 3101	.71	Reports on Comparative Financial Statements: Report of Predecessor Auditor: Predecessor Auditor's Report Reissued	Amend	p. A3-28
AS 3305 (currently AU sec. 623), <i>Special Reports</i>	.31	Circumstances Requiring Explanatory Language in an Auditor's Special Report	Amend	p. A3-29
AS 4105, <i>Reviews of Interim Financial Information</i> (currently AU sec. 722, <i>Interim Financial Information</i> )	.18	Analytical Procedures, Inquiries, and Other Review Procedures	Make conforming amendment	p. A3-32
AS 4105	.39-.40	The Accountant's Report on a Review of Interim Financial Information: Form of Accountant's Review Report	Make conforming amendment	p. A3-35
AS 6115 (currently Auditing Standard No.4), <i>Reporting on Whether a Previously Reported Material Weakness Continues to Exist</i>	.24	Planning the Engagement	Make conforming amendment	p. A3-38

PCAOB Standard or Rule	Paragraph, Section, or Appendix	Subject Heading of Paragraph(s) or Appendix Affected	Action	Page
AS 6115	.40	Opinions, Based in Part, on the Work of Another Auditor	Amend	p. A3–38
Rule 1001	(p)(ii)	Play a Substantial Role in the Preparation or Furnishing of an Audit Report	Make conforming amendment	p. A3–39

**AS 1301 (currently Auditing Standard No. 16), *Communications with Audit Committees***

\* \* \*

**Obtaining Information and Communicating the Audit Strategy**

\* \* \*

**Overall Audit Strategy, Timing of the Audit, and Significant Risks**

\* \* \*

.10 As part of communicating the overall audit strategy, the auditor should communicate the following matters to the audit committee, if applicable:

- a. The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks;<sup>9</sup>
- b. The extent to which the auditor plans to use the work of the company's internal auditors in an audit of financial statements;<sup>10</sup>

- c. The extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting;<sup>11</sup>
- d. ~~The names, locations, and planned responsibilities<sup>12</sup> of other independent public accounting firms or other persons, who are not employed by the auditors,~~ that perform audit procedures in the current period audit or referred-to auditors that audit portions of the company's financial statements in the current period audit and, if applicable, internal control over financial reporting;<sup>12A</sup> and

~~Note: The term "other independent public accounting firms" in the context of this communication includes firms that perform audit procedures in the current period audit regardless of whether they otherwise have any relationship with the auditor.~~

- e. ~~The basis for the auditor's determination that the auditor can serve as principal auditor, if significant parts of the audit are to be performed by other auditors~~In an audit that involves other auditors or referred-to auditors, the basis for the engagement partner's determination that the participation of his or her firm is sufficient to serve as the lead auditor.<sup>13</sup>

<sup>9</sup> See AS 2101.16 for the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

<sup>10</sup> See AS 2605, *Consideration of the Internal Audit Function*, which describes the auditor's responsibilities related to the work of internal auditors.

<sup>11</sup> See paragraphs .16–.19 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which describe the auditor's responsibilities related to using the work of others in an audit of internal control over financial reporting.

<sup>12</sup> See AS 2101.08–.14, which discuss the auditor's responsibilities for determining the audit strategy, audit plan, and extent to which audit procedures should be performed at selected locations or business units involving multi-location engagements.

<sup>12A</sup> The terms "other auditor" and "referred-to auditor" in this standard have the same meaning as in Appendix A of AS 2101, *Audit Planning*.

<sup>13</sup> See AS 1205, *Part of the Audit Performed by Other Independent Auditors*, which discusses the professional judgments the auditor makes in deciding whether the auditor may serve as principal auditor; AS 2101.B2 and .B3, which establish requirements regarding serving as the lead auditor.

\* \* \*

**AS 2110 (currently Auditing Standard No. 12), *Identifying and Assessing Risks of Material Misstatement***

\* \* \*

***Obtaining an Understanding of the Company and Its Environment***

\* \* \*

**Nature of the Company**

\* \* \*

.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. Such matters may include transactions, adjustments, or other matters that have come to the attention of the lead auditor and may require adjustment to or disclosure in the financial statements audited by the referred-to auditor.

\* \* \*

**AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements***

\* \* \*

**APPENDIX B – Special Topics**

\* \* \*

**Use of Service Organizations**

\* \* \*

.B23 In determining whether the service auditor's report provides sufficient evidence to support the auditor's opinion, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor ~~are discussed in paragraph .10a of AS 1205, *Part of the Audit Performed by Other Independent Auditors*~~ may include professional organizations and other relevant parties.

\* \* \*

**APPENDIX C – Special Reporting Situations**

**Report Modifications**

.C1 The auditor should modify his or her report if any of the following conditions exist.

- a. Elements of management's annual report on internal control are incomplete or improperly presented,
- b. There is a restriction on the scope of the engagement,
- c. The auditor decides to refer to the report of another public accounting firm ~~auditors~~ as the basis, in part, for the auditor's own report,

- d. There is other information contained in management's annual report on internal control over financial reporting, or
- e. Management's annual certification pursuant to Section 302 of the Sarbanes-Oxley Act is misstated.

\* \* \*

~~.C8 *Opinions Based, in Part, on the Report of Another Public Accounting Firm Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. AS 1205, *Part of the Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements must participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting. Because an audit of the financial statements must be performed to audit internal control over financial reporting, only the lead auditor of the financial statements can be the lead auditor of internal control over financial reporting. In an audit that involves other auditors or referred-to auditors, the lead auditor of the consolidated financial statements must participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the lead auditor of internal control over financial reporting.~~\*

\* AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, establishes requirements for situations in which the lead auditor of the consolidated financial statements and, if applicable, internal control over financial reporting makes reference in the auditor's report to the referred-to auditor's report on the financial statements and, if applicable, internal control over financial reporting of one or more of the company's business units. See Appendix A of AS 2101, *Audit Planning*, for the definitions of lead auditor, other auditor, and referred-to auditor. See

a/so AS 2101.B2 and .B3, which establish requirements regarding serving as the lead auditor.

~~.C9—When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AS 1205.~~

~~.C10 The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's assessment of internal control over financial reporting ordinarily would not extend to controls at the equity method investee. The lead auditor's decision about making reference to the referred-to auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by the referred-to auditor, but the report on internal control over financial reporting might not make a similar reference because management's assessment of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.<sup>1</sup>~~

<sup>1</sup> See paragraph .B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

~~.C11 When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the company's internal control over financial reporting, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinion. When the lead auditor makes reference to the report of the referred-to auditor as a basis, in part, for the lead auditor's opinion on the company's internal control over financial reporting, the lead auditor should refer to the report of the referred-to auditor when describing the scope of the audit and when expressing the opinion.~~

\* \* \*

**AS 2401 (currently AU sec. 316), *Consideration of Fraud in a Financial Statement Audit***

\* \* \*

**Responding to Assessed Fraud Risks**

\* \* \*

**Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed**

\* \* \*

.53 The following are examples of responses to assessed fraud risks involving the nature, timing, and extent of audit procedures:

- Performing procedures at locations on a surprise or unannounced basis, for example, observing inventory on unexpected dates or at unexpected locations or counting cash on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Making oral inquiries of major customers and suppliers in addition to sending written confirmations, or sending confirmation requests to a specific party within an organization.
- Performing substantive analytical procedures using disaggregated data, for example, comparing gross profit or operating margins by location, line of business, or month to auditor-developed expectations.<sup>20</sup>
- Interviewing personnel involved in activities in areas in which a fraud risk has been identified to obtain their insights about the risk and how controls address the risk. (See AS 2110.54)

- If other ~~independent auditors~~ or referred-to auditors are auditing the financial statements of one or more ~~subsidiaries, divisions, or branches~~ of the company's business units, discussing with them the extent of work that needs to be performed to address the fraud risk resulting from transactions and activities among these ~~components~~ business units.<sup>20A</sup>

<sup>20</sup> AS 2305 (currently Auditing Standard No. 329), *Substantive Analytical Procedures*, establishes requirements regarding performing analytical procedures as substantive tests.

<sup>20A</sup> AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, establishes requirements for the lead auditor regarding dividing responsibility for the audit of the company's financial statements and, if applicable, internal control over financial reporting with a referred-to auditor.

\* \* \*

### **Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls**

\* \* \*

.61 The auditor should use professional judgment in determining the nature, timing, and extent of the testing of journal entries and other adjustments. For purposes of identifying and selecting specific entries and other adjustments for testing, and determining the appropriate method of examining the underlying support for the items selected, the auditor should consider:

- *The auditor's assessment of the fraud risk.* The presence of fraud risk factors or other conditions may help the auditor to identify specific classes of journal entries for testing and indicate the extent of testing necessary.
- *The effectiveness of controls that have been implemented over journal entries and other adjustments.* Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the controls. However, even though controls might be implemented and

operating effectively, the auditor's substantive procedures for testing journal entries and other adjustments should include the identification and substantive testing of specific items.

- *The entity's financial reporting process and the nature of the evidence that can be examined.* The auditor's procedures for testing journal entries and other adjustments will vary based on the nature of the financial reporting process. For many entities, routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments might involve both manual and automated procedures and controls. Regardless of the method, the auditor's procedures should include selecting from the general ledger journal entries to be tested and examining support for those items. In addition, the auditor should be aware that journal entries and other adjustments might exist in either electronic or paper form. When information technology (IT) is used in the financial reporting process, journal entries and other adjustments might exist only in electronic form. Electronic evidence often requires extraction of the desired data by an auditor with IT knowledge and skills or the use of an IT specialist. In an IT environment, it may be necessary for the auditor to employ computer-assisted audit techniques (for example, report writers, software or data extraction tools, or other systems-based techniques) to identify the journal entries and other adjustments to be tested.
- *The characteristics of fraudulent entries or adjustments.* Inappropriate journal entries and other adjustments often have certain unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or a consistent ending number.
- *The nature and complexity of the accounts.* Inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain

significant estimates and period-end adjustments, (c) have been prone to errors in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain intercompany transactions, or (f) are otherwise associated with an identified fraud risk. In audits of entities that have multiple locations or business units, the auditor should determine whether to select journal entries from locations or business units based on factors set forth in paragraphs .11 through .14 of AS 2101, *Audit Planning*.

- *Journal entries or other adjustments processed outside the normal course of business.* Standard journal entries used on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements, or to record recurring periodic accounting estimates generally are subject to the entity's internal controls. Nonstandard entries (for example, entries used to record nonrecurring transactions, such as a business combination, or entries used to record a nonrecurring estimate, such as an asset impairment) might not be subject to the same level of internal control. In addition, other adjustments such as consolidating adjustments, report combinations, and reclassifications generally are not reflected in formal journal entries and might not be subject to the entity's internal controls. Accordingly, the auditor should consider placing additional emphasis on identifying and testing items processed outside of the normal course of business.

\* \* \*

### **AS 2410 (currently Auditing Standard No. 18), *Related Parties***

\* \* \*

#### ***Performing Risk Assessment Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties***

.03 The auditor should perform procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with AS 2110, *Identifying and Assessing Risks of Material Misstatement*. The procedures performed to

obtain an understanding of the company's relationships and transactions with its related parties include:

- a. Obtaining an understanding of the company's process (paragraph .04);
- b. Performing inquiries (paragraphs .05–.07); and
- c. Communicating with the ~~audit~~ engagement team and ~~other~~referred-to auditors (paragraphs .08–.09).

Note: Obtaining an understanding of the company's relationships and transactions with its related parties includes obtaining an understanding of the nature of the relationships between the company and its related parties and of the terms and business purposes (or the lack thereof) of the transactions involving related parties.

Note: Performing the risk assessment procedures described in paragraphs .04–.09 of this standard in conjunction with the risk assessment procedures required by AS 2110 is intended to provide the auditor with a reasonable basis for identifying and assessing risks of material misstatement associated with related parties and relationships and transactions with related parties.

\* \* \*

*Communicating with the ~~Audit~~ Engagement Team and ~~Other~~Referred-to Auditors*

\* \* \*

.09 If the auditor is ~~using the work of another~~uses as the lead auditor and divides responsibility for the audit with a referred-to auditor, the lead auditor should communicate to the ~~other~~referred-to auditor relevant information about related parties, including the names of the company's related parties and the nature of the company's relationships and transactions with those related parties.<sup>9</sup> 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.

<sup>9</sup> See ~~AS 1205, Part of the Audit Performed by Other Independent Auditors~~, which describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or

~~more subsidiaries, divisions, branches, components, or investments included in the financial statements paragraphs .B2 and .B3 of AS 2101, *Audit Planning*, which establish requirements regarding serving as the lead auditor. See also AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, which establishes requirements for the lead auditor regarding dividing responsibility for the audit with a referred-to auditor.~~

\* \* \*

***Evaluating Whether the Company Has Properly Identified Its Related Parties and Relationships and Transactions with Related Parties***

\* \* \*

.16 If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

- a. Inquire of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
- b. Evaluate why the related party or relationship or transaction with a related party was previously undisclosed to the auditor;<sup>17</sup>
- c. Promptly communicate to appropriate members of the engagement team and ~~the referred-to auditor~~~~other auditors participating in the audit engagement~~ relevant information about the related party or relationship or transaction with the related party;
- d. Assess the need to perform additional procedures to identify other relationships or transactions with the related party previously undisclosed to the auditor;
- e. Perform the procedures required by paragraph .12 of this standard for each related party transaction previously undisclosed to the auditor that is required to be disclosed in the financial statements or determined to be a significant risk; and

- f. Perform the following procedures, taking into account the information gathered from performing the procedures in a. through e. above:
  - i. Evaluate the implications on the auditor's assessment of internal control over financial reporting, if applicable;
  - ii. Reassess the risk of material misstatement and perform additional procedures as necessary if such reassessment results in a higher risk;<sup>18</sup> and
  - iii. Evaluate the implications for the audit if management's nondisclosure to the auditor of a related party or relationship or transaction with a related party indicates that fraud or an illegal act may have occurred. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, the auditor must determine his or her responsibilities under AS 2401.79–.82, AS 2405 (currently AU sec. 317), *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1.

<sup>17</sup> See AS 2805.04, which states that if a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.

<sup>18</sup> See AS 2110.74, which states that when the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.

\* \* \*

**AS 2503 (currently AU sec. 332), *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities***

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**Designing Substantive Procedures Based on Risk Assessments**

\* \* \*

**Financial Statement Assertions**

\* \* \*

***Valuation***

.28 *Valuation Based on an Investee's Financial Results.* For valuations based on an investee's financial results, including but not limited to the equity method of accounting, the auditor should obtain sufficient evidence in support of the investee's financial results. The auditor should read available financial statements of the investee and the accompanying audit report, if any. Financial statements of the investee that have been audited by an auditor whose report is satisfactory, for this purpose,<sup>14</sup> to the investor's auditor may constitute sufficient evidential matter.

<sup>14</sup> In determining whether the report of ~~another~~the investee's auditor is satisfactory for this purpose, the auditor may consider performing procedures such as making inquiries as to the professional reputation and standing of the ~~other~~investee's auditor, visiting the ~~other~~investee's auditor and discussing the audit procedures followed and the results thereof, and reviewing the audit program and/or working papers of the ~~other~~investee's auditor.

\* \* \*

**AS 2601, *Consideration of an Entity's Use of a Service Organization* (currently AU sec. 324, *Service Organizations*)**

**Introduction and Applicability**

.01 This section provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity that uses a service

organization to process certain transactions. This section also provides guidance for independent auditors who issue reports on the processing of transactions by a service organization for use by another auditor~~other auditors~~.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs .B17–.B27 of Appendix B, *Special Topics*, of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, regarding the use of service organizations.

\* \* \*

## Considerations in Using a Service Auditor's Report

.18 In considering whether the service auditor's report is satisfactory for his or her purposes, the user auditor should make inquiries concerning the service auditor's professional reputation. Appropriate sources of information concerning the professional reputation of the service auditor ~~are discussed in paragraph .10a of AS 1205, *Part of the Audit Performed by Other Independent Auditors*~~may include professional organizations and other relevant parties.

.19 In considering whether the service auditor's report is sufficient to meet his or her objectives, the user auditor should ~~give consideration to the guidance in AS 1205.12~~consider performing one or more of the following procedures:

- Visiting the service auditor and discussing the audit procedures followed and results thereof.
- Reviewing the audit programs of the service auditor. In some cases, it may be appropriate to issue instructions to the service auditor as to the scope of the audit work.
- Reviewing additional audit documentation of the service auditor.

If the user auditor believes that the service auditor's report may not be sufficient to meet his or her objectives, the user auditor may supplement his or her understanding of the service auditor's procedures and conclusions by discussing with the service auditor the scope and results of the service auditor's work. Also, if the user auditor believes it is necessary, he or she may contact the service organization, through the

user organization, to request that the service auditor perform agreed-upon procedures at the service organization, or the user auditor may perform such procedures.

\* \* \*

***AS 2605, Consideration of the Internal Audit Function (currently AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements)***

\* \* \*

**Extent of the Effect of the Internal Auditors' Work**

\* \* \*

.19 The responsibility to report on the financial statements rests solely with the auditor. Unlike the situation in which the lead auditor uses the work of other independent auditors ~~divides responsibility for the audit with another public accounting firm~~,<sup>6</sup> this responsibility cannot be shared with the internal auditors. Because the auditor has the ultimate responsibility to express an opinion on the financial statements, judgments about assessments of inherent and control risks, the materiality of misstatements, the sufficiency of tests performed, the evaluation of significant accounting estimates, and other matters affecting the auditor's report should always be those of the auditor.

<sup>6</sup> See ~~AS 1205, Part of the Audit Performed by Other Independent Auditors~~ AS 1206, Dividing Responsibility for the Audit with Another Accounting Firm.

\* \* \*

**AS 2610, Initial Audits—Communications Between Predecessor and Successor Auditors (currently AU sec. 315, Communications Between Predecessor and Successor Auditors)**

\* \* \*

**Successor Auditor's Use of Communications**

.12 The successor auditor must obtain sufficient appropriate evidential matter to afford a reasonable basis for expressing an opinion on the financial statements he or she has been engaged to audit, including evaluating the consistency of the application of accounting principles. The audit evidence used in analyzing the impact of the opening balances on the current-year financial statements and consistency of accounting principles is a matter of professional judgment. Such audit evidence may include the most recent audited financial statements, the predecessor auditor's report thereon,<sup>8</sup> the results of inquiry of the predecessor auditor, the results of the successor auditor's review of the predecessor auditor's working papers relating to the most recently completed audit, and audit procedures performed on the current period's transactions that may provide evidence about the opening balances or consistency. For example, evidence gathered during the current year's audit may provide information about the realizability and existence of receivables and inventory recorded at the beginning of the year. The successor auditor may also apply appropriate auditing procedures to account balances at the beginning of the period under audit and to transactions in prior periods.

<sup>8</sup> The successor auditor may wish to make inquiries about the professional reputation and standing of the predecessor auditor. ~~See paragraph .10a of AS 1205, *Part of the Audit Performed by Other Independent Auditors* to one or more professional organizations or other relevant parties.~~

\* \* \*

**Audits of Financial Statements That Have Been Previously Audited**

.14 If an auditor is asked to audit and report on financial statements that have been previously audited and reported on (henceforth referred to as a reaudit), the auditor considering acceptance of the reaudit engagement is also a successor auditor, and the auditor who previously reported is also a predecessor auditor. In addition to the communications described in paragraphs .07 through .10, the successor auditor

should state that the purpose of the inquiries is to obtain information about whether to accept an engagement to perform a reaudit.

\* \* \*

.16 The successor auditor should plan and perform the reaudit in accordance with the standards of the PCAOB. The successor auditor should not assume responsibility for the predecessor auditor's work or issue a report that reflects divided responsibility for that work as described in AS 1205~~6~~. Furthermore, the predecessor auditor is not a specialist as defined in AS 1210, *Using the Work of a Specialist*, nor does the predecessor auditor's work constitute the work of others as described in AS 2605, *Consideration of the Internal Audit Function*, or paragraphs .16–.19 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

\* \* \*

### **AS 2710 (currently AU sec. 550), *Other Information in Documents Containing Audited Financial Statements***

\* \* \*

.04 Other information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report. The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.<sup>2</sup> If the auditor concludes that there is a material inconsistency, he should determine whether the financial statements, his report, or both require revision. If he concludes that they do not require revision, he should request the client to revise the other information. If the other information is not revised to eliminate the material inconsistency, he should communicate the material inconsistency to the audit committee and consider other actions, such as revising his report to include an explanatory paragraph describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement. The action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

<sup>2</sup> In fulfilling his responsibility under this section, a ~~principal~~lead auditor may also request the other auditor or referred-to auditors ~~involved in the engagement~~ to read the other information. If a predecessor auditor's report appears in a document to which this section applies, he should read the other information for the reasons described in this paragraph. (See Appendix A of AS 2101, *Audit Planning*, for the definitions of lead auditor, other auditor, and referred-to auditor.)

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### **AS 3101 (currently AU sec. 508), *Reports on Audited Financial Statements***

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#### **Explanatory Language Added to the Auditor's Standard Report**

.11 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory<sup>9</sup> paragraph (or other explanatory language) to the standard report.<sup>10</sup> These circumstances include:

- a. ~~The auditor's opinion is based in part on the report of another auditor (paragraphs .12 and .13)~~The auditor divides responsibility with, and makes reference in the auditor's report to the audit and report of, another accounting firm.<sup>10A</sup>
- b. There is substantial doubt about the entity's ability to continue as a going concern.<sup>11</sup>
- c. There has been a material change between periods in accounting principles or in the method of their application (paragraphs .17A through .17E).
- d. A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C).
- e. Certain circumstances relating to reports on comparative financial statements exist (paragraphs .68, .69, and .72 through .74).

- f. Selected quarterly financial data required by SEC Regulation S-K has been omitted or has not been reviewed. (See paragraph .50 of AS 4105, *Reviews of Interim Financial Information*.)
- g. Supplementary information required by the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), or the Federal Accounting Standards Advisory Board (FASAB) has been omitted, the presentation of such information departs materially from FASB, GASB, or FASAB guidelines, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to FASB, GASB, or FASAB guidelines. (See paragraph .02 of AS 2705 (currently AU sec. 558), *Required Supplementary Information*.)
- h. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements. (See paragraph .04 of AS 2710 (currently AU sec. 550), *Other Information in Documents Containing Audited Financial Statements*.)

In addition, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (paragraph .19).

<sup>9</sup> Unless otherwise required by the provisions of this section, an explanatory paragraph may precede or follow the opinion paragraph in the auditor's report.

<sup>10</sup> See footnote 3.

<sup>10A</sup> AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, establishes requirements for situations in which the auditor of the consolidated financial statements ("lead auditor") makes reference in the auditor's report to the report of another accounting firm that audited the financial statements of one or more of the company's business units ("referred-to auditor"). (See also paragraphs .B2 and .B3 of AS 2101, *Audit Planning*, which establish requirements regarding serving as the lead auditor.)

<sup>11</sup> AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern* (currently AU sec. 341, *The Auditor's Consideration of an Entity's Ability to*

*Continue as a Going Concern*), describes the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and, when applicable, to consider the adequacy of financial statement disclosure and to include an explanatory paragraph in the report to reflect his or her conclusions.

**Opinion Based in Part on Report of Another Auditor**  
**Dividing Responsibility for the Audit with the Referred-to Auditor**

.12 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, he or she should disclose this fact in the introductory paragraph of his or her report and should refer to the report of the other auditor in expressing his or her opinion. These references indicate division of responsibility for performance of the audit. (See AS 1205, *Part of the Audit Performed by Other Independent Auditors*.) When the lead auditor divides responsibility for the audit with the referred-to auditor, the lead auditor's report should make reference to the audit and report of the referred-to auditor in compliance with the requirements of AS 1206.08–.10.

.13 An example of a report indicating a division of responsibility follows:

Report of Independent Registered Public Accounting Firm

We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of \$ \_\_\_\_\_ and \$ \_\_\_\_\_ as of December 31, 20X2 and 20X1, respectively, and total revenues of \$ \_\_\_\_\_ and \$ \_\_\_\_\_ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance

~~about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.~~

~~In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

\* \* \*

## **Reports on Comparative Financial Statements**

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## **Report of Predecessor Auditor**

\* \* \*

### ***Predecessor Auditor's Report Reissued***

.71 Before reissuing (or consenting to the reuse of) a report previously issued on the financial statements of a prior period, when those financial statements are to be presented on a comparative basis with audited financial statements of a subsequent period, a predecessor auditor should consider whether his or her previous report on those statements is still appropriate. Either the current form or manner of presentation of the financial statements of the prior period or one or more subsequent events might make a predecessor auditor's previous report inappropriate. Consequently, a predecessor auditor should (a) read the financial statements of the current period, (b) compare the prior-period financial statements that he or she reported on with the financial statements to be presented for comparative purposes, and (c) obtain representation letters from management of the former client and from the successor auditor. The representation letter from management of the former client should state (a)

whether any information has come to management's attention that would cause them to believe that any of the previous representations should be modified, and (b) whether any events have occurred subsequent to the balance-sheet date of the latest prior-period financial statements reported on by the predecessor auditor that would require adjustment to or disclosure in those financial statements.<sup>28</sup> The representation letter from the successor auditor should state whether the successor's audit revealed any matters that, in the successor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor auditor. Also, the predecessor auditor may wish to consider: ~~the matters described in AS 1205.10 through .12(a) making inquiries about the professional reputation and standing of the successor auditor,~~<sup>28A</sup> (b) obtaining a representation from the successor auditor that he or she is independent under the requirements of the PCAOB and the SEC, and (c) making inquiries of the successor auditor to determine that the successor auditor knows the relevant requirements of the applicable financial reporting framework, standards of the PCAOB, and financial reporting requirements of the SEC. However, the predecessor auditor should not refer in his or her reissued report to the report or work of the successor auditor.

<sup>28</sup> See AS 2805 (currently AU sec. 333), *Management Representations*, appendix C [paragraph .18], "Illustrative Updating Management Representation Letter."

<sup>28A</sup> Inquiries may be made to one or more professional organizations or other relevant parties.

\* \* \*

## **AS 3305 (currently AU sec. 623), *Special Reports***

\* \* \*

### **Circumstances Requiring Explanatory Language in an Auditor's Special Report**

.31 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add additional explanatory language to the special report. These circumstances include the following:

- a. *Lack of Consistency in Accounting Principles.* If there has been a change in accounting principles or in the method of their application,<sup>35</sup> the auditor

should add an explanatory paragraph to the report (following the opinion paragraph) that describes the change and refers to the note to the financial presentation (or specified elements, accounts, or items thereof) that discusses the change and its effect thereon<sup>36</sup> if the accounting change is considered relevant to the presentation. Guidance on reporting in this situation is contained in AS 3101.16 through .18.

- b. *Going Concern Uncertainties.* If the auditor has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statement, the auditor should add an explanatory paragraph after the opinion paragraph of the report only if the auditor's substantial doubt is relevant to the presentation.<sup>39</sup>
- c. ~~*Referred-to-Other Auditors.* When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, the auditor should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing his or her opinion. Guidance on reporting in this situation is contained in AS 3101.12 and .13 divides responsibility for the audit with another accounting firm, the auditor's report should make reference to the audit and report of the referred-to auditor in compliance with the requirements of paragraphs .08–.10 of AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm.*<sup>40</sup>~~
- d. *Comparative Financial Statements (or Specified Elements, Accounts, or Items Thereof).* If the auditor expresses an opinion on prior-period financial statements (or specified elements, accounts, or items thereof) that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph preceding the opinion paragraph of the report. Guidance on reporting in this situation is contained in AS 3101.68 and .69.

As in reports on financial statements prepared in conformity with generally accepted accounting principles, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (or specified elements, accounts, or items thereof).

<sup>35</sup> When financial statements (or specified elements, accounts, or items thereof) have been prepared in conformity with generally accepted accounting principles in prior years, and the entity changes its method of presentation in the current year by preparing its financial statements in conformity with an other comprehensive basis of accounting, the auditor need not follow the reporting guidance in this subparagraph. However, the auditor may wish to add an explanatory paragraph to the report to highlight (1) a difference in the basis of presentation from that used in prior years or (2) that another report has been issued on the entity's financial statements prepared in conformity with another basis of presentation (for example, when cash basis financial statements are issued in addition to GAAP financial statements).

<sup>36</sup> A change in the tax law is not considered to be a change in accounting principle for which the auditor would need to add an explanatory paragraph, although disclosure may be necessary.

[<sup>37–38</sup>] [Footnotes deleted.]

<sup>39</sup> See AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*, for a report example when the auditor has substantial doubt about the entity's ability to continue as a going concern.

<sup>40</sup> AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, establishes requirements for situations in which the auditor of the consolidated financial statements ("lead auditor") makes reference in the auditor's report to the report of another accounting firm that audited the financial statements of one or more of the company's business units. (See also paragraphs .B2 and .B3 of AS 2101, *Audit Planning*, which establish requirements regarding serving as the lead auditor.)

\* \* \*

**AS 4105, *Reviews of Interim Financial Information* (currently AU sec. 722, *Interim Financial Information*)**

\* \* \*

**Analytical Procedures, Inquiries, and Other Review Procedures**

\* \* \*

.18 *Inquiries and other review procedures.* The following are inquiries the accountant should make and other review procedures the accountant should perform when conducting a review of interim financial information:

- a. Reading the available minutes of meetings of stockholders, directors, and appropriate committees, and inquiring about matters dealt with at meetings for which minutes are not available, to identify matters that may affect the interim financial information.
- b. Obtaining reports from other accountants, if any, who have been engaged to perform a review of the interim financial information of significant components of the reporting entity, its subsidiaries, or its other investees, or inquiring of those accountants if reports have not been issued.<sup>11</sup>
- c. Inquiring of members of management who have responsibility for financial and accounting matters concerning:
  - Whether the interim financial information has been prepared in conformity with generally accepted accounting principles consistently applied.
  - Unusual or complex situations that may have an effect on the interim financial information. (See Appendix B [paragraph .55] of this section for examples of unusual or complex situations about which the accountant ordinarily would inquire of management.)
  - Significant transactions occurring or recognized in the last several days of the interim period.

- The status of uncorrected misstatements identified during the previous audit and interim review (that is, whether adjustments had been recorded subsequent to the prior audit or interim period and, if so, the amounts recorded and period in which such adjustments were recorded).
  - Matters about which questions have arisen in the course of applying the review procedures.
  - Events subsequent to the date of the interim financial information that could have a material effect on the presentation of such information.
  - Their knowledge of any fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.
  - Whether they are aware of allegations of fraud or suspected fraud affecting the entity, for example, received in communications from employees, former employees, analysts, regulators, short sellers, or others.
  - Significant journal entries and other adjustments.
  - Communications from regulatory agencies.
  - Significant deficiencies, including material weaknesses, in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data.
- d.* Obtaining evidence that the interim financial information agrees or reconciles with the accounting records. For example, the accountant may compare the interim financial information to (1) the accounting records, such as the general ledger; (2) a consolidating schedule derived from the accounting records; or (3) other supporting data in the entity's records. In addition, the accountant should consider inquiring of management as to the reliability of the records to which the interim financial information was compared or reconciled.

- e. Reading the interim financial information to consider whether, based on the results of the review procedures performed and other information that has come to the accountant's attention, the information to be reported conforms with generally accepted accounting principles.
- f. Reading other information that accompanies the interim financial information and is contained in reports (1) to holders of securities or beneficial interests or (2) filed with regulatory authorities under the Securities Exchange Act of 1934 (such as Form 10-Q or 10-QSB), to consider whether such information or the manner of its presentation is materially inconsistent with the interim financial information.<sup>12</sup> If the accountant concludes that there is a material inconsistency, or becomes aware of information that he or she believes is a material misstatement of fact, the action taken will depend on his or her judgment in the particular circumstances. In determining the appropriate course of action, the accountant should consider the guidance in paragraphs .04 through .06 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*.
- g. Evaluating management's quarterly certifications about internal control over financial reporting by performing the following procedures —
  - Inquiring of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;
  - Evaluating the implications of misstatements identified by the auditor as part of the auditor's other interim review procedures as they relate to effective internal control over financial reporting; and
  - Determining, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

<sup>11</sup> In these circumstances, the accountant ordinarily is in a position similar to that of the lead auditor. ~~(See paragraphs .B2 and .B3 of AS 2101, *Audit Planning*, which establish requirements regarding serving as the lead auditor.) an auditor who acts as principal auditor (see AS 1205, *Part of the Audit Performed by Other Independent Auditors*) and makes use of the work or reports of other auditors in the course of an audit of financial statements.~~

<sup>12</sup> The principal accountant also may request other accountants involved in the engagement, if any, to read the other information.

\* \* \*

## **The Accountant's Report on a Review of Interim Financial Information<sup>24</sup>**

### **Form of Accountant's Review Report**

<sup>24</sup> Paragraphs .37 through .46 of this section provide reporting guidance for a review of interim financial information; however, an accountant is not required to issue a report on such engagements.

\* \* \*

.39 An accountant may be engaged to report on a review of comparative interim financial information. The following is an example of a review report on a condensed balance sheet as of March 31, 20X1, the related condensed statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and a condensed balance sheet derived from audited financial statements as of December 31, 20X0, that were included in Form 10-Q.<sup>27</sup>

#### **Report of Independent Registered Public Accounting Firm**

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0. These financial statements are the responsibility of the company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and

making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board, the consolidated balance sheet of ABC Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.<sup>28</sup>

[*Signature*]

[*City and State or Country*]

[*Date*]

<sup>27</sup> Regulation S-X specifies that the following financial information should be provided in filings on Form 10-Q:

- a. An interim balance sheet as of the end of the most recent fiscal quarter and a balance sheet as of the end of the preceding fiscal year that may be condensed to the same extent as the interim balance sheet.
- b. Interim condensed statements of income for the most recent fiscal quarter, for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year.

- c. Interim condensed cash flow statements for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter and for the corresponding period for the preceding fiscal year.

<sup>28</sup> If the auditor's report on the preceding year-end financial statements was other than unqualified, ~~referred to other auditors~~ made reference to an audit and auditor's report of another accounting firm, or included an explanatory paragraph because of a going-concern matter or an inconsistency in the application of accounting principles, the last paragraph of the illustrative report in paragraph .39 should be appropriately modified.

.40 The accountant may use and make reference to another accountant's review report on the interim financial information of a significant component of a reporting entity. This reference indicates a division of responsibility for performing the review.<sup>29</sup> The following is an example of report including such a reference:

Report of Independent Registered Public Accounting Firm

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. This (These) interim financial information (statements) is (are) the responsibility of the company's management.

We were furnished with the report of other accountants on their review of the interim financial information of DEF subsidiary, whose total assets as of September 30, 20X1, and whose revenues for the three-month and nine-month periods then ended, constituted 15 percent, 20 percent, and 22 percent, respectively, of the related consolidated totals.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information (statements) consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the

financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review and the report of other accountants, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[City and State or Country]

[Date]

<sup>29</sup> See AS 1205~~6~~, Dividing Responsibility for the Audit with Another Accounting Firm.

\* \* \*

### **AS 6115 (currently Auditing Standard No. 4), *Reporting on Whether a Previously Reported Material Weakness Continues to Exist***

\* \* \*

#### **Planning the Engagement**

.24 The auditor should properly plan the engagement to report on whether a previously reported material weakness continues to exist and should properly supervise engagement team members~~any~~ assistants. When planning the engagement, the auditor should evaluate how the matters described in AS 2201.09 will affect the auditor's procedures.

\* \* \*

#### **Opinions, Based in Part, on the Work of Another Auditor Engagements Involving Other Accounting Firms**

.40 The auditor may apply the relevant concepts in AS 1205, Part of the Audit Performed by Other Independent Auditors, in if an engagement to report on whether a previously reported material weakness continues to exist involves another accounting

~~firm, the lead, with the following exception. If the auditor decides to serve as the principal auditor and to use the work and reports of another auditor as a basis, in part, for his or her opinion, the principal auditor must not divide responsibility for the engagement with the other auditor accounting firm. Therefore, the principal auditor must not make reference to the other auditor in his or her report.~~

\* \* \*

### **Rule 1001. *Definitions of Terms Employed in Rules***

When used in the Rules, unless the context otherwise requires:

\* \* \*

#### **(p)(ii) Play a Substantial Role in the Preparation or Furnishing of an Audit Report**

The phrase "play a substantial role in the preparation or furnishing of an audit report" means –

- (1) to perform material services that a public accounting firm uses or relies on in issuing all or part of its audit report, or
- (2) to perform the majority of the audit procedures with respect to a subsidiary or component of any issuer, broker, or dealer, the assets or revenues of which constitute 20% or more of the consolidated assets or revenues of such issuer, broker, or dealer necessary for the ~~principal~~ lead auditor to issue an audit report.

Note 1: For purposes of paragraph (1) of this definition, the term "material services" means services, for which the engagement hours or fees constitute 20% or more of the total engagement hours or fees, respectively, provided by the ~~principal~~ lead auditor in connection with the issuance of all or part of its audit report. The term does not include non-audit services provided to non-audit clients.

Note 2: For purposes of paragraph (2) of this definition, the phrase "subsidiary or component" is meant to include any subsidiary, division, branch, office or other component of an issuer, broker, or dealer, regardless of its form of organization and/or control relationship with the issuer, broker, or dealer.

Note 3: For purposes of determining "20% or more of the consolidated assets or revenues" under paragraph (2) of this Rule, this determination should be made at the beginning of the issuer's, broker's, or dealer's fiscal year using prior year information and should be made only once during the issuer's, broker's, or dealer's fiscal year.

## **APPENDIX 4**

### **Additional Discussion of Proposed Amendments and Proposed New Standard**

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#### **I. Introduction**

This proposal is intended to improve the quality of audits that involve firms and accountants outside the accounting firm issuing the audit report (collectively "other auditors"). This appendix discusses in more detail amendments to existing auditing standards and a new auditing standard proposed by the Public Company Accounting Oversight Board ("PCAOB" or "Board") relating to the use of other auditors and dividing responsibility for the audit with another accounting firm ("proposal" or "Board's proposal").

In brief, the Board's proposal includes:

- Proposed amendments to AS 1201 (currently Auditing Standard No. 10), *Supervision of the Audit Engagement*,<sup>1</sup> AS 2101 (currently Auditing

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<sup>1</sup> In 2015, the PCAOB adopted and the U.S. Securities and Exchange Commission ("SEC") approved the reorganization of PCAOB auditing standards using a topical structure and a single, integrated numbering system. See *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*,

Standard No. 9), *Audit Planning*, AS 1220 (currently Auditing Standard No. 7), *Engagement Quality Review*, and AS 1215 (currently Auditing Standard No. 3), *Audit Documentation*, ("proposed amendments"), which are included in Appendix 1 of this release; and

- Proposed new auditing standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, for situations in which the accounting firm issuing the audit report divides responsibility for the audit with another accounting firm.

In general, this proposal (1) retains the existing approach under PCAOB standards for the relatively infrequent situations in which the lead auditor divides responsibility with another auditor and (2) extends the existing risk-based approach to supervision to apply to all other situations in which firms and accountants outside the accounting firm issuing the audit report participate in an audit. Both the proposed standard and the proposed amendments contain improved requirements and additional direction that sets forth the responsibilities of the lead auditor, the auditor issuing the auditor's report, in these situations. For example, the proposal would require the lead auditor to, among other things, supervise the work of other auditors pursuant to AS 1201, as amended by the proposal, unless the lead auditor divides responsibility for the audit with another auditor.

**A. Comparison with Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board**

This appendix also includes a comparison of this proposal with the analogous requirements of the following standards issued by the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA"). The following IAASB and ASB standards are included in the comparison:

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PCAOB Release No. 2015-002 (Mar. 31, 2015); SEC, *Public Company Accounting Oversight Board; Order Granting Approval of Proposed Rules To Implement the Reorganization of PCAOB Auditing Standards and Related Changes to PCAOB Rules and Attestation, Quality Control, and Ethics and Independence Standards*, Exchange Act Release No. 75935 (Sept. 17, 2015), 80 FR 57263 (Sept. 22, 2015). The reorganized amendments will be effective as of December 31, 2016, but may be used and referenced before that date. See PCAOB Release No. 2015-002, at 21.

*IAASB Standards*

- International Standard on Auditing 220, *Quality Control for an Audit of Financial Statements* ("ISA 220");
- International Standard on Auditing 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* ("ISA 600"); and
- International Standard on Quality Control 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* ("ISQC 1").

*ASB Standards*

- AU-C Section 220, *Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards* ("AU-C Section 220");
- AU-C Section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* ("AU-C Section 600"); and
- AICPA, Statement on Quality Control Standards No. 8, *A Firm's System of Quality Control (Redrafted)* ("SQCS No. 8").

The comparison included in the appendix may not represent the views of the IAASB or ASB regarding the interpretation of their standards. The information presented in this appendix does not cover the application and explanatory material in the IAASB standards or ASB standards.<sup>2</sup>

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<sup>2</sup> Paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, indicates that the application and other explanatory material section of the ISAs "does not in itself impose a requirement" but "is relevant to the proper application of the requirements of an ISA." Paragraph .A64 of AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that, although application and other explanatory

Importantly, ISA 600 and AU-C 600 employ a different approach from the Board's proposal. ISA 600 and AU-C 600 set forth requirements for "group audits" performed by a "group engagement team" and "component auditors." Group audits are audits of "group financial statements" consisting of at least two "components." Group audits seemingly are designed for an audit engagement team organized around the financial reporting structures of companies with multiple financial reporting units. Group audits can be performed by a single firm or multiple firms. Also, ISA 600 and AU-C 600 address other matters such as multi-location scoping that are already addressed in existing PCAOB standards.<sup>3</sup>

In contrast, this proposal applies to all audit engagements involving other auditors, regardless of the company's financial reporting structure, and this proposal focuses on the lead auditor's responsibilities with respect to involvement with the other auditors.

#### **B. Requests for Comment**

The Board requests comments on specific questions that are included in this appendix, as well as on the proposal in general.

## **II. Terminology – Proposed Definitions**

To operationalize the proposed requirements, this proposal includes proposed definitions of "engagement team," "lead auditor," "other auditor," and "referred-to auditor."

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material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section."

<sup>3</sup> See, e.g., AS 2101.11–.14, paragraph .10 of AS 2105, (currently Auditing Standard No. 11), *Consideration of Materiality in Planning and Performing an Audit*, and paragraphs .33 and .B10–.B16 of AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

**A. Proposed Definition of "Engagement Team"**

*See proposed paragraph .A3 of AS 1201 and AS 2101 in Appendix 1*

According to existing PCAOB standards, the engagement partner is responsible for proper supervision of the work of engagement team members.<sup>4</sup> The term "engagement team" is used in existing PCAOB auditing standards but is not expressly defined. The proposed definition of "engagement team" would specify the persons subject to supervision under AS 1201, extending the range of supervision to cover other auditors for whose work the lead auditor currently assumes responsibility under AS 1205.

Specifically, the proposed definition of "engagement team" would include: (1) partners, principals, and shareholders of, and accountants<sup>5</sup> and other professional staff employed or engaged by, the lead auditor or other accounting firms, who perform audit procedures on an audit or assist the engagement partner in fulfilling his or her planning or supervisory responsibilities on the audit pursuant to AS 2101 or AS 1201 and (2) specialists whose work is used on the audit and who are employed by the lead auditor or another accounting firm participating in the audit.

The proposed definition of "engagement team" would *not* include: (1) the engagement quality reviewer and those assisting the reviewer (to which AS 1220 applies), (2) partners, principals, and shareholders of, and other individuals employed or engaged by, another accounting firm in situations in which the lead auditor divides responsibility for the audit with the other firm under proposed AS 1206, or (3) engaged specialists.<sup>6</sup>

The following are examples of individuals who would be considered members of the engagement team under the Board's proposal:

- Personnel of accounting firms other than the lead auditor and individual accountants outside the lead auditor's firm (engaged directly or through

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<sup>4</sup> See AS 1201.03.

<sup>5</sup> See paragraph (a)(ii) in PCAOB Rule 1001, *Definitions of Terms Employed in Rules*.

<sup>6</sup> See AS 1210 (currently AU sec. 336), *Using the Work of a Specialist*.

other accounting firms, consulting firms, or temporary workforce agencies) whose work the lead auditor currently supervises under AS 1201.

- Personnel of accounting firms described in AS 1205 (currently AU sec. 543), *Part of the Audit Performed by Other Independent Auditors*, (which would be superseded by the proposal) as other auditors for whose work the principal auditor (current AS 1205 term) assumes responsibility.

By including these individuals in the engagement team, the proposal would expand the lead auditor's responsibility to apply the risk-based supervision approach to all accounting firms, except in situations in which the lead auditor divides responsibility for the audit with another accounting firm. (If the lead auditor divides responsibility for the audit with an accounting firm, that firm would be considered a referred-to auditor under proposed AS 1206.)

- An individual from a firm's national office who performs audit procedures on the audit.

For example, if an individual from the national office is seconded to the engagement team to obtain an understanding of the methods and assumptions used by a specialist in the valuation of securities held by the company, he or she would be considered a member of the engagement team.

The following are examples of individuals who would not be considered members of the engagement team under the Board's proposal:

- Engagement quality reviewer and those assisting the reviewer, to which AS 1220 applies.<sup>7</sup>

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<sup>7</sup> In some situations, individuals from U.S. accounting firms, including from their national offices, review the work of non-U.S. accounting firms in accordance with one of the Board's quality control standards, known as Appendix K. See SEC Practice Section ("SECPS") Section 1000.45 Appendix K, *SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants*. The Board adopted Appendix K as part of its interim standards. See Rule 3400T(b), *Interim Quality Control Standards*, SECPS Section 1000.08(n). Appendix K requires accounting firms associated with international

- Specialists engaged by the auditor. The Board's proposal would not change the requirement that the auditor apply AS 1210, when using the work of engaged specialists in fields other than accounting or auditing.<sup>8</sup>
- Service auditors who issue reports on the controls of a service organization and whose report is used by the engagement team to support the auditor's opinion as described in AS 2601, *Consideration of an Entity's Use of a Service Organization* (currently AU sec. 324, *Service Organizations*).
- An individual from a firm's national office who provides a consultation on the audit, but does not perform audit procedures or supervise the work of the audit.
- Individuals employed or engaged, directly or indirectly, by the company being audited. Such individuals may include, for example, the company's internal auditors, company's specialists, company's consultants, or others. Because of their roles at the company, the work of individuals employed or engaged by the company is not subject to supervision under AS 1201; they would not be considered members of the engagement team under the proposal. Existing PCAOB standards include requirements regarding the auditor's use of work performed by some of these individuals.<sup>9</sup>

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firms to seek the adoption of policies and procedures consistent with certain objectives, including having policies and procedures for certain filings of SEC registrants which are the clients of foreign associated firms to be reviewed by persons knowledgeable in PCAOB standards. Because Appendix K reviewers do not make decisions on behalf of the engagement team or assume any of the responsibilities of the engagement team, similar to the engagement quality reviewer, the reviewers would not be considered members of the engagement team.

<sup>8</sup> The Board has a separate standard-setting project regarding specialists, which could result in changes to the auditor's responsibilities regarding the auditor's use of the work of specialists and, in turn, could result in changes to AS 1201 as well as other standards.

<sup>9</sup> See, e.g., AS 2605, *Consideration of the Internal Audit Function* (currently AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*), or paragraphs .16–.19 of AS 2201 (currently Auditing Standard

Neither the proposed definition of "engagement team" nor any of the amendments in this proposal would affect the applicability of the independence and ethics requirements of the Board or the SEC to audits involving other auditors. While the proposed amendments would include certain individuals in, or exclude certain other individuals from, the definition of engagement team in PCAOB standards, the Board's proposal would not change the applicability or the meaning of engagement team in the context of the PCAOB's or SEC's independence rules.<sup>10</sup>

**B. Proposed Definition of "Lead Auditor"**

*See proposed paragraph .A4 of AS 1201 and AS 2101 and proposed paragraph .A2 of the Proposed New Standard AS 1206*

The proposal introduces the term "lead auditor" for supervising other auditors under AS 1201 and dividing responsibility under proposed AS 1206. Under the proposal, the term "lead auditor" applies to the firm issuing the auditor's report or supervisory personnel from that firm, depending on the context.

Specifically, the term "lead auditor" would be defined as follows:

Lead auditor –

- (a) The registered public accounting firm<sup>11</sup> 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:

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No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

<sup>10</sup> For example, the individuals covered by the Board's proposed definition of "engagement team" are also covered by the definition of "audit engagement team" in the SEC's independence rules. See Rule 2-01(f)(7)(i) of Regulation S-X, 17 CFR 210.2-01(f)(7)(i). The definition in SEC Rule 2-01(f)(7)(i) also covers certain individuals who are not covered by the Board's proposed definition of "engagement team," such as the engagement quality reviewer.

<sup>11</sup> See paragraph (r)(i) in PCAOB Rule 1001, *Definitions of Terms Employed in Rules*, which defines the term "registered public accounting firm."

(i) are partners, principals, shareholders, or employees of the registered public accounting firm issuing the auditor's report and

(ii) assist the engagement partner in fulfilling his or her planning or supervisory responsibilities on the audit pursuant to AS 2101 or AS 1201.<sup>12</sup>

The proposed definition is consistent with the concept in existing PCAOB standards,<sup>13</sup> that the engagement partner may seek assistance from other engagement team members in fulfilling his or her planning and supervisory responsibilities.

As with any assigned responsibility on an audit, the engagement partner should seek planning or supervisory assistance only from engagement team members with the necessary knowledge, skill, and ability, and that would apply to those assisting in the supervision of other auditors.<sup>14</sup> This includes, for example, sufficient knowledge of a particular industry to assist the engagement partner in supervising the other auditor's work at a company's operations in that industry.

### **C. Proposed Definitions of "Other Auditor" and "Referred-to Auditor"**

*See proposed paragraph .A5 of AS 1201 and AS 2101 for the term "other auditor" and proposed paragraph .A6 of AS 2101 and .A3 of the Proposed New Standard AS 1206 for the term "referred-to auditor"*

Currently several PCAOB standards use the term "other auditor" to encompass any other auditors that participate in an audit, regardless of whether the lead auditor supervises them under AS 1201, assumes responsibility under AS 1205, or

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<sup>12</sup> See paragraph .05a of AS 2301 (currently Auditing Standard No. 13), *The Auditor's Responses to the Risks of Material Misstatement*, which describes making appropriate assignments of significant engagement responsibilities. See also paragraph .06 of AS 1015 (currently AU sec. 230), *Due Professional Care in the Performance of Work* according to which "[a]uditors should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability."

<sup>13</sup> See, e.g., AS 1201.04 and AS 2101.03.

<sup>14</sup> See, e.g., AS 2301.05a and AS 1015.06.

makes reference to them under AS 1205.<sup>15</sup> But existing PCAOB standards do not define the term "other auditor." This proposal adopts two definitions: "other auditor," which applies to those supervised under AS 1201, as proposed to be amended, and "referred-to auditor," which applies when the lead auditor divides responsibility.

The proposed definitions are:

Other auditor – (a) A member of the engagement team who is not a partner, principal, shareholder, or employee of the lead auditor; and (b) a public accounting firm, if any, of which such engagement team member is a partner, principal, shareholder, or employee.

Referred-to auditor – A public accounting firm, other than the lead auditor, that performs an audit of the financial statements and, if applicable, internal control over financial reporting of one or more of the company's business units<sup>16</sup> and issues an auditor's report in accordance with the standards of the PCAOB to which the lead auditor makes reference in the lead auditor's report on the company's financial statements and, if applicable, internal control over financial reporting.

The "other auditor" definition encompasses both the individuals participating in the audit and their firm. In contrast, the referred-to auditor definition applies only to the firm because the firm issues an auditor's report in the divided responsibility situation.

#### **D. Comparison with Standards of Other Standard Setters**

ISA 600 uses the terms "group engagement team" and "component auditor" as follows:

Group engagement team – Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate

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<sup>15</sup> For example, AS 1205 uses this term to describe accounting firms whose work the lead auditor uses or with which it divides responsibility for the audit; AS 1215.18 and .19 use the term "other auditor" when describing offices of the firm issuing the audit report and other firms participating in the audit.

<sup>16</sup> The term "business units" includes subsidiaries, divisions, branches, components, or investments.

the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements; and

Component auditor – An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

In contrast, other IAASB standards use the term "engagement team." For example, paragraph 7 of ISA 220 provides the following definition:

Engagement team – All partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform audit procedures on the engagement. This excludes an auditor's external expert engaged by the firm or a network firm.

IAASB standards do not contain requirements for situations in which the auditor divides responsibility for the audit with another independent public accounting firm.

AU-C Section 600 has the same definition for the group engagement team. Under AU-C Section 600, component auditor is defined as follows:

Component auditor – An auditor who performs work on the financial information of a component that will be used as audit evidence for the group audit. A component auditor may be part of the group engagement partner's firm, a network firm of the group engagement partner's firm, or another firm.

Similar to the IAASB standards, other ASB standards use the term "engagement team." For example, AU-C Section 220 defines the term the same as defined in ISA 220.

ASB standards include requirements for situations in which the auditor divides responsibility for the audit with another independent public accounting firm. Unlike proposed AS 1206, ASB standards do not include a specific term analogous to the proposed term "referred-to auditor" to distinguish from other component auditors an accounting firm with which the auditor divides responsibility for the audit.

*Questions:*

16. 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?

17. 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?
18. Are there any situations in practice where applying the new definitions of "engagement team" and "other auditor," including related requirements, would present practical challenges?
19. 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?
20. 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?

### **III. Proposed Amendments to AS 2101**

The proposal includes a number of amendments to the standard for audit planning, AS 2101. In general, these amendments either retain and update requirements from AS 1205, which is proposed to be superseded, or amend existing requirements to specify that they be performed by the lead auditor. These amendments primarily relate to:

- Determining the sufficiency of a firm's participation to serve as lead auditor in an audit that involves other auditors or referred-to auditors;
- Determining locations and business units at which audit procedures should be performed in an audit that involves other auditors or referred-to auditors;
- Determining compliance of other auditors with SEC and PCAOB independence and ethics requirements;
- Determining registration status of other auditors that play a "substantial role" on an audit; and
- Understanding the qualifications of other auditors and determining the lead auditor's ability to communicate with other auditors.

This section of the appendix discusses proposed planning requirements for audits in which the lead auditor supervises the work of other auditors in accordance with AS 1201 and certain proposed planning requirements included in AS 2101 for audits in which the lead auditor divides responsibility for the audit with referred-to auditors in accordance with proposed AS 1206.<sup>17</sup>

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<sup>17</sup> In addition, Section VII of this appendix discusses, among other things, requirements for the lead auditor in proposed AS 1206 relating to the referred-to auditor's (1) compliance with the SEC and PCAOB independence and ethics requirements, (2) registration pursuant to the rules of the PCAOB, and (3) knowledge of the relevant accounting, auditing, and financial reporting requirements.

**A. Determining the Sufficiency of a Firm's Participation to Serve as Lead Auditor in an Audit that Involves Other Auditors or Referred-to Auditors**

*See proposed paragraph .B2 of AS 2101*

Currently, in situations governed by AS 1205, when significant parts of the audit are performed by "other auditors" or "referred-to auditors" (as these terms are defined by the proposal), the lead auditor must decide whether the auditor's own participation is sufficient to enable the auditor to issue the auditor's report on the company's financial statements.<sup>18</sup> This proposal would retain the requirement to determine sufficiency of participation as part of audit planning and revise it as described below.

Under existing AS 1205, when making this decision, the auditor is required to consider, among other things, (i) the materiality of the portion of the financial statements audited in comparison with the portion audited by other auditors; (ii) the extent of the auditor's knowledge of the overall financial statements; and (iii) the importance of the components audited by the auditor in relation to the enterprise as a whole.

The proposal would revise the requirement to determine the sufficiency of participation by (i) extending the required determination to apply to all audits involving other auditors and referred-to auditors (not just those covered by AS 1205 today); (ii) imposing the determination requirement specifically on the engagement partner; and (iii) requiring that the determination be based on the risks of material misstatement associated with the portions of the financial statements audited by the engagement partner's firm relative to the portion audited by the other auditors.

Extending the sufficiency of participation determination to all audits involving other auditors and referred-to auditors and imposing the determination requirement on the engagement partner is intended to increase the likelihood that the firm issuing the auditor's report performs audit procedures for a meaningful portion of the company's financial statements.

The proposed determination would be based on the risks of material misstatement associated with the portion of the company's financial statements audited by the engagement partner's firm (including the portion's materiality) in comparison with the portions for which the other auditors perform audit procedures or the portions

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See AS 1205.02.

audited by the referred-to auditors. Describing a sufficiency of participation criterion in terms of risk, rather than "importance" as in AS 1205, would be more consistent with the requirements in PCAOB standards for determining the scope of audit work in a multi-location engagement.<sup>19</sup> The proposed risk-based criterion is intended to capture both quantitative as well as qualitative characteristics of a particular scenario.<sup>20</sup> Under this criterion, the lead auditor ordinarily would need to audit the location at which the primary financial reporting decisions were made and the consolidated financial statements were prepared in order to address the risks related to those important judgments and activities, and a sufficient number of other locations to cover a greater portion of the risks than any of the other audit firms performing procedures on the audit.

Because planning is not a discrete phase of an audit, but is instead a continual and iterative process,<sup>21</sup> the engagement partner is expected to revisit his or her determination of the sufficiency of the lead auditor's participation throughout the course of the audit if circumstances change. This may happen, for example, if the lead auditor assigns more responsibilities to another accounting firm than originally planned, or if the company acquires another company that is audited by another accounting firm after the initial decisions are made, or if the risk profile changes due to other unforeseen events.

The following are examples of possible applications of the proposed requirements in hypothetical situations, which are similar to situations observed in the Board's oversight activities. These examples have been provided for illustrative purposes only. Similar situations in practice accompanied by additional information could lead to different conclusions. Accounting firms described in the examples may be from the same network of firms as the lead auditor, different networks, or unaffiliated with any such network.

*Example 1*—A multinational company with locations or business units in more than 100 countries has its global headquarters in Country A. The headquarters include the offices of the chief executive officer ("CEO"), chief financial officer ("CFO"), and controller, who are responsible for key operational, financial, and reporting decisions and for significant management judgments that are necessary for preparing the company's consolidated financial statements.

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<sup>19</sup> See, e.g., AS 2101.11–.14.

<sup>20</sup> See also the discussion of key policy choices related to the determination of sufficiency of participation in Section IV.D.3(i) of this release at 47.

<sup>21</sup> See AS 2101.05.

Approximately one-third of the company's worldwide operations (revenues and assets) are in Country A. The chairman of the board and several of the company's senior executives work in Country B. However, only five percent of the company's worldwide operations are in Country B.

Accounting Firm 1 is located in Country A and performs audit procedures with respect to the company's global headquarters and operations in Country A. Accounting Firm 2 is located in Country B and performs audit procedures with respect to the company's operations in Country B. Other firms perform audit procedures with respect to the company's operations in other countries, none of which represents more than 10 percent of the company's operations. The identified risks of material misstatement to the consolidated financial statements which are associated with the company's operations in Country A are greater than in Country B or other countries, in part, because key operational, financial, and reporting decisions and significant management judgments are made by executives located in Country A.

Under the proposal, the participation of Accounting Firm 1 would be sufficient for the firm to carry out the responsibilities of a lead auditor and to report as such on the company's financial statements. Greater risks of material misstatement are associated with the portion of the company's operations audited by Accounting Firm 1 than with portions audited by the other auditors. The company's revenue and assets audited by Accounting Firm 1 are the largest portion of revenue and assets in comparison with the remaining individual portions audited by the other auditors or referred-to auditors.

Despite the fact that Accounting Firm 2 performs audit procedures with respect to the company's operations in Country B in which the chairman of the board and several of the company's senior executives work, the participation of this firm would not be sufficient to serve as the lead auditor because greater risks of material misstatement are associated with the portion of financial statements audited by Accounting Firm 1 than with the portion audited by Accounting Firm 2.

*Example 2*—A multinational company operates in eight countries and its global headquarters are located in Country A. The headquarters include the offices of the CEO, CFO, and controller, who are responsible for key financial and reporting decisions, including the significant management judgments necessary to prepare the company's financial statements, such as selection of accounting policies and important asset and liability valuations. Additionally, the

headquarters location is responsible for the consolidation and preparation of the company's financial statements. Headquarters personnel also execute all significant financing and investing activities and determine the accounting for those activities, even significant assets owned by and recorded in the financial statements of a country subsidiary. The company's operations in Country A contribute only 10 percent of consolidated revenue, however.

The company's activities in the other countries consist of routine sales and operating activities, which involve no significant accounting judgments. Those activities have not significantly changed over the past several years.

Accounting Firm 1, located in Country A, performs audit procedures with respect to Country A, which represents 10 percent of worldwide revenue and includes the company's headquarters. For company operations in the other countries, the largest of which represent 15, 18, and 20 percent of the worldwide revenue, audit procedures are performed by an accounting firm located in the respective country.

Under the proposal, the participation of Accounting Firm 1 would be sufficient to carry out the responsibilities of a lead auditor and to report as such on the company's consolidated financial statements. Accounting Firm 1 performs audit procedures with respect to the location that poses the greatest risk of material misstatement to the consolidated financial statements, including the risks related to the consolidation and financial statement preparation, significant accounting judgments, and complex accounting issues. Thus, although other accounting firms might perform audit procedures with respect to larger portions of the company's worldwide revenue than Accounting Firm 1, the risks of material misstatement associated with the portion of the company's financial statements audited by Accounting Firm 1 are relatively greater than the risk at the other individual locations. If the locations in the other countries had more complex operations with higher risks of material misstatement, Accounting Firm 1 would likely need to cover one or more other locations in addition to Country A in order to satisfy the sufficiency criteria in the proposal.

*Example 3*—A company located in Country A plans to hire Accounting Firm 1 located in Country B to perform an audit of, and issue the audit report on, the company's financial statements. The engagement partner and audit manager with Accounting Firm 1 plan to use Accounting Firm 2, which is located in Country A, to perform audit procedures on company's principal operations in

Country A that would constitute substantially all of the audit procedures on the company's financial statements.

Under the proposal, despite the fact that the engagement partner and manager are with Accounting Firm 1, the participation of Accounting Firm 1 in the audit would not be sufficient to serve as the lead auditor because substantially all of the audit procedures on the company's financial statements would be performed by another firm. The conclusion would be the same if Accounting Firms 1 and 2 were in the same network of firms or if the engagement partner and audit manager (who are from Country B) were in Country A for the duration of the audit. The Board's proposal is not intended to provide a way for an auditor to take responsibility for the work of another auditor that has essentially audited a company's financial statements in their entirety.

*Comparison with Standards of Other Standard Setters*

Paragraph 8a of ISA 600 states that an objective of the auditor is to determine whether to act as the auditor of the group financial statements. Paragraph 12 of ISA 600 states, among other things, that where component auditors will perform work on the financial information of such components, the group engagement partner shall evaluate whether the group engagement team will be able to be involved in the work of those component auditors to the extent necessary to obtain sufficient appropriate audit evidence. Paragraph 13 of ISA 600 includes requirements for situations in which the group engagement partner concludes that it will not be possible for the group engagement team to obtain sufficient appropriate audit evidence due to restrictions imposed by group management; and the possible effect of this inability will result in a disclaimer of opinion on the group financial statements. ISA 220 requires that the engagement partner take responsibility for the direction, supervision, performance, and review of the audit engagement and for being satisfied that sufficient appropriate audit evidence has been obtained on which to base the auditor's opinion on the financial statements.<sup>22</sup>

AU-C Section 600 contains requirements that are similar to those in ISA 600.

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<sup>22</sup> See paragraphs 15–17 of ISA 220.

**B. Determining Locations and Business Units at Which Audit Procedures Should Be Performed in an Audit that Involves Other Auditors or Referred-to Auditors**

*See proposed amendments to paragraph .14 of AS 2101*

Other auditors are often involved in audits of companies with operations in multiple locations and business units ("multi-location engagements"). Some of the existing requirements for such audits in PCAOB standards differ depending on whether AS 1201 or AS 1205 applies, as follows:

- In situations governed by AS 1201, paragraph .11 of AS 2101 requires determining (i) the locations at which audit procedures should be performed and (ii) the nature, timing, and extent of the procedures.
- In situations governed by AS 1205, the lead auditor is required to determine the locations and business units of a company at which audit procedures should be performed.<sup>23</sup>

The proposed amendments specify that the lead auditor would be required to determine the locations and business units at which audit procedures should be performed in all audits that involve "other auditors" and "referred-to auditors" (as proposed to be defined). When making this determination, the lead auditor would be required to hold discussions with and obtain information from the other auditors or referred-to auditors, as necessary, to identify and assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit.

These amendments, together with the amended supervisory requirements in AS 1201, are intended to make sure the lead auditor plays the central role in determining the overall audit scope in such audits. Based on information from the Board's oversight activities, the Board's proposal is consistent with the approach taken by a number of accounting firms.

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<sup>23</sup>

See AS 2101.14.

*Comparison with Standards of Other Standard Setters*

Paragraph 24 of ISA 600 states that the group engagement team shall determine the type of work to be performed by the group engagement team, or the component auditors on its behalf, on the financial information of the components; and that the group engagement team shall also determine the nature, timing, and extent of its involvement in the work of the component auditors. For a component that is significant due to its individual financial significance to the group, paragraph 26 of ISA 600 states that the group engagement team, or a component auditor on its behalf, shall perform an audit of the financial information of the component using component materiality. For a component that is significant because it is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances, paragraph 27 of ISA 600 states that the group engagement team, or a component auditor on its behalf, shall perform one or more of the following: (a) an audit of the financial information of the component using component materiality; (b) an audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks of material misstatement of the group financial statements; or (c) specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements. For components that are not significant components, paragraph 28 of ISA 600 states that the group engagement team shall perform analytical procedures at the group level.<sup>24</sup>

When the auditor of the group financial statements uses a component auditor's work, the requirements in AU-C Section 600 are similar to ISA 600.<sup>25</sup>

ISA 600 does not contain requirements for situations in which the auditor divides responsibility for the audit with another accounting firm. AU-C Section 600 requires that the auditor design and implement appropriate responses to address the assessed risks of material misstatement of the financial statements.<sup>26</sup>

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<sup>24</sup> Paragraph 29 of ISA 600 describes the group engagement team's further course of action with respect to components that are not significant components if the group engagement team does not consider that sufficient appropriate audit evidence on which to base the group audit opinion will be obtained through the performance of certain procedures.

<sup>25</sup> See paragraphs .33 and .52–.58 of AU-C Section 600.

<sup>26</sup> See paragraph .33 of AU-C Section 600.

**C. Determining Compliance of Other Auditors with Independence and Ethics Requirements**

*See proposed paragraph .B4 of AS 2101*

Currently, paragraph .06b of AS 2101 requires the auditor to determine compliance with independence and ethics requirements. In addition, for situations governed by AS 1205, paragraph .10 of AS 1205 requires the lead auditor ("principal auditor," as used in the terminology of AS 1205) to make inquiries concerning the other auditor's independence. Such inquiries may include, for example, obtaining a representation from the other auditor that the other auditor is independent.<sup>27</sup>

Under PCAOB Rule 3520, *Auditor Independence*, all auditors involved in the audit (including the firms and personnel of the lead auditor and other auditors), must be independent of the audit client throughout the audit and professional engagement period. This requirement for the lead auditors and other auditors not only extends to the independence rules and standards of the PCAOB but also extends to the rules and regulations of the SEC under the federal securities laws.

The proposal would retain the overarching requirement in AS 2101.06b to determine the audit engagement's compliance with independence and ethics requirements. In lieu of the AS 1205 requirement, the proposal would require the lead auditor, in all audits in which the lead auditor supervises other auditors,<sup>28</sup> to determine each other auditor's compliance with the SEC and PCAOB independence and ethics requirements by:

- 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
- Obtaining a written representation from each other auditor that it is in compliance with SEC and PCAOB independence and ethics requirements.

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<sup>27</sup> See AS 1205.10b.

<sup>28</sup> For the divided responsibility scenario, see discussion of proposed requirements of AS 1206 below in Section VII.B.3 of this appendix.

Additionally, the lead auditor would be required to reassess the other auditor's compliance with ethics and independence requirements if circumstances change, for example, if the other auditor is engaged by the business unit under audit to perform additional non-audit services. This will necessitate ongoing communication between the lead auditor and other auditor during the audit so that the lead auditor can be informed about relevant changes in circumstances. Furthermore, the proposal provides that if, during the audit, the lead auditor becomes aware of information that contradicts a representation made by the other auditor regarding its compliance with the SEC and PCAOB independence and ethics requirements the lead auditor would be required to perform additional procedures to determine the effect of the information on the independence of the other auditor.

The proposal does not prescribe specific procedures for obtaining an understanding of the other auditors' knowledge of the SEC and PCAOB independence and ethics requirements, and their experience in applying the requirements. Sources of relevant information about other auditors may differ depending, for example, on whether the lead auditor and other auditors are affiliated with the same network of audit firms. The following are examples of types 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:

- The type, frequency, and substance of independence and ethics training that the other auditor provides to its personnel who participate in the audit;
- The other auditor's policies and procedures for ensuring that the firm and its personnel comply with the independence and ethics requirements, including compliance with PCAOB Rule 3520, *Auditor Independence*;<sup>29</sup>
- The other auditor's process for determining that the other auditor, including the firm and its applicable personnel, do not have financial or employment relationships that might impair the lead auditor's independence on the audit;<sup>30</sup>

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<sup>29</sup> See also QC Sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

<sup>30</sup> See Regulation S-X Rules 2-01(c)(1) and 2-01(c)(2).

- The other auditor's process for obtaining timely information about the audit client and its affiliates from which the other auditor firm is required to maintain independence, including an understanding of all non-audit services initiated or about to be initiated for the audit client;<sup>31</sup> and
- Any business relationships between the other auditor (including the firm and its applicable personnel) and the audit client, or persons associated with the audit client in a decision-making capacity, such as officers, directors, or substantial stockholders.<sup>32</sup>

*Comparison with Standards of Other Standard Setters*

Paragraph 19(a) of ISA 600 states that the group engagement team shall obtain an understanding of, among other things, whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent.

According to paragraph 40(b) of ISA 600, the group engagement team shall communicate the requirements relevant to the group audit to a component auditor on a timely basis, and this communication shall include, among other things, the ethical requirements that are relevant to the group audit and in particular, the independence requirements.

AU-C Section 600 contains requirements that are similar to those in ISA 600.

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<sup>31</sup> PCAOB and SEC independence rules define "affiliate of the audit client" at PCAOB Rule 3501(a)(ii) and Regulation S-X Rule 2-01(f)(4). For rules regarding the prohibition of non-audit services, see Regulation S-X Rules 2-01(c)(4) and 2-01(b), PCAOB Rule 3522, *Tax Transactions*, and PCAOB Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*. See also PCAOB Rule 3521, *Contingent Fees*.

<sup>32</sup> See Regulation S-X Rule 2-01(c)(3).

**D. Registration Status of Other Auditors that Play a Substantial Role on an Audit**

*See proposed paragraph .B5 of AS 2101*

Existing PCAOB Rule 2100 requires a public accounting firm to be registered if the firm: (a) prepares or issues any audit report with respect to any issuer, broker, or dealer or (b) plays a substantial role in the preparation or furnishing of an audit report with respect to any issuer, broker, or dealer. However, there have been situations in which a firm playing a substantial role on an audit was not registered pursuant to the rules of the PCAOB.

The proposal provides that the lead auditor may use the work of an other auditor that would play a substantial role only if the other auditor is registered pursuant to the rules of the PCAOB. The proposal does not change Rule 2100 or the related definition, but is intended to promote compliance with the existing rule.

*Comparison with Standards of Other Standard Setters*

The IAASB and ASB do not have analogous requirements.

**E. Understanding the Qualifications of Other Auditors and Determining the Lead Auditor's Ability to Communicate with Other Auditors and Gain Access to Their Work Papers**

*See proposed paragraph .B6 of AS 2101*

PCAOB standards have long recognized the importance of technical training and proficiency of the personnel performing the audit, and this is particularly important for senior engagement personnel.<sup>33</sup>

In situations in which the lead auditor supervises the other auditors in accordance with AS 1201, existing PCAOB standards require that the knowledge, skill, and ability of engagement team members with significant engagement responsibilities should be commensurate with the assessed risks of material misstatement.<sup>34</sup>

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<sup>33</sup> See, e.g., AS 1010 and QC 20.11-.12.

<sup>34</sup> See AS 2301.5.a.

In situations in which the lead auditor uses the other auditor's work in accordance with AS 1205, existing PCAOB standards require the lead auditor ("principal auditor" in the terminology of AS 1205) to make inquiries concerning the professional reputation of the other auditor.<sup>35</sup> This may include, among other things, ascertaining the other auditor's familiarity with accounting principles generally accepted in the United States of America and with the standards of the PCAOB.<sup>36</sup>

The Board's proposal builds on and strengthens the existing requirements by requiring that when planning the audit the lead auditor: (i) gain an understanding of the qualifications of the other auditors who assist the lead auditor with planning or supervision and (ii) determine that the lead auditor is able to communicate with the other auditors and gain access to the work of other auditors. The proposed requirements seek to apply a balanced and practical approach by focusing the lead auditor's attention on the qualifications of the more senior engagement team members of the other auditor, that is, those who assist the lead auditor with planning or supervision. The proposal would allow the lead auditor to seek assistance from these senior engagement team members, when appropriate, for certain procedures with respect to supervising the work of other engagement team members at the other auditor.<sup>37</sup>

### **1. *Understanding the Qualifications of Other Auditors***

Gaining an understanding of the knowledge, skill, and ability of the other auditor's supervisory personnel is necessary for determining the extent of the lead auditor's supervision of the other auditors. Lack of appropriate qualifications by other auditors who assist the lead auditor with planning or supervision could have an adverse effect on the effectiveness of supervision and may increase the likelihood that auditors would not identify material misstatements in the company's financial statements.

Gaining an understanding of the qualifications under the proposal would necessarily involve gaining an understanding of the knowledge, skill, and ability of the relevant personnel, for example, experience in the industry or in the jurisdiction<sup>38</sup> in

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<sup>35</sup> See AS 1205.10.

<sup>36</sup> See AS 1205.10c(ii).

<sup>37</sup> See, e.g., AS 1015.06 and AS 1201.06.

<sup>38</sup> The proposal would add an explanatory phrase "including relevant knowledge of foreign jurisdictions" to AS 2101.16.

which the company operates, knowledge of the relevant financial reporting framework, and knowledge of PCAOB standards and rules, and of SEC rules and regulations. Possible sources of information that are relevant to the lead auditor's understanding of the other auditors' qualifications include the lead auditor's own experience working with the relevant personnel, information about training or internal inspection results regarding those personnel, and publicly disclosed disciplinary action by regulators against relevant personnel.

**2. *Determining the Lead Auditor's Ability to Communicate with Other Auditors and Gain Access to Their Work Papers***

The proposed requirement to determine the auditor's ability to communicate with the other auditors and gain access to their working papers is designed to alert the lead auditor to difficulties it may encounter in obtaining and evaluating audit evidence collected by other auditors so that the lead auditor may take appropriate action. For example, privacy laws of certain jurisdictions may create obstacles for the transfer of the other auditor's documentation from the country in which the other auditor is located to the lead auditor's country. In these instances, engagement team members from the lead auditor may need to travel to the country where the working papers are located to access the working papers and perform their review. However, if effective methods of remote access to the working papers are available to the lead auditor, the proposal would not preclude the use of such methods. The proposal would not change the existing requirement in AS 1215.19 for obtaining, reviewing, and retaining certain documentation related to the other auditor's work by the office of the firm issuing the auditor's report.

If the lead auditor cannot obtain sufficient appropriate audit evidence, a limitation on the scope of the audit may exist. This may require the engagement partner to qualify the audit opinion or disclaim an opinion.<sup>39</sup>

*Comparison with Standards of Other Standard Setters*

Paragraph 19 of ISA 600 includes provisions regarding the group engagement team's understanding of the component auditor and requires that, if the group engagement team plans to request a component auditor to perform work on the

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<sup>39</sup> See AS 2810.35. See also paragraphs .22 through .34 of AS 3101 (currently AU sec. 508), *Reports on Audited Financial Statements*, which contains requirements regarding audit scope limitations.

financial information of a component, the group engagement team obtain an understanding of, among other things:

- The component auditor's professional competence; and
- The group engagement team's ability to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.

AU-C Section 600 contains requirements that are similar to those in ISA 600.

*Questions:*

21. 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?
22. 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?
23. 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?
24. 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?

25. 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?
26. 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?
27. 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?
28. 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?
29. 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?

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

#### **IV. Proposed Amendments to AS 1201**

##### **A. Overview of the Proposed Supervisory Approach**

The Board's proposal is intended to improve the quality of audits that involve other auditors for whom the lead auditor assumes responsibility by requiring, among other things, that the lead auditor supervise the other auditors under AS 1201, as proposed to be amended.

Currently, the risk-based supervision approach described in AS 1201 does not apply to situations in which the lead auditor uses the work and reports of other auditors under AS 1205. The proposal would supersede AS 1205 and extend the application of AS 1201 to all audits involving other auditors for which the lead auditor assumes responsibility, which in turn should improve the lead auditor's supervision of other auditors. Under the proposal, the extent of the lead auditor's supervision of the work of other auditors is based on, among other things, the risks of material misstatement to the company's financial statements and the knowledge, skill, and ability of the other auditor.<sup>40</sup>

Additionally, the proposal would provide more specific direction for the supervision of other auditors.

Currently, AS 1201 sets forth the general framework for supervision of engagement team members, including the nature and extent of supervisory activities. It also states that the engagement partner is responsible for supervision but may seek assistance from appropriate engagement team members. It does not, however, delineate the responsibilities of the lead auditor from those of other auditor supervisory personnel.

When other auditors participate in the audit, the lead auditor, as the firm that issues the audit report, is responsible for making sure that sufficient appropriate audit evidence has been obtained, and appropriately evaluated, to support the opinion in the audit report. Because of the lead auditor's central role in the audit, the Board's proposal

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<sup>40</sup> See AS 1201.06 and proposed AS 1201.B1.

would require that certain supervisory procedures be performed by the lead auditor. These proposed procedures would constitute an integral part of the supervisory activities described by AS 1201; they are designed to improve the effectiveness of the lead auditor's supervision of the work of other auditors under AS 1201. The proposed procedures are described in more detail later in this appendix.

Effective supervision typically necessitates two-way interaction with the supervised party. Thus, the Board's proposal would require the lead auditor to hold discussions with and obtain information from the other auditors as necessary for the performance of the proposed procedures. The proposed amendments are intended to foster effective interaction between the lead auditor and other auditors.

The proposed approach to the lead auditor's supervision of other auditors would be consistent with, and take into account recent developments at some accounting firms, which have been observed through the Board's oversight activities.

**B. Proposed Supervision Procedures to Be Performed by the Lead Auditor**

To facilitate the supervision of the other auditors, the proposed amendments would establish specific requirements for the lead auditor in the following areas:

- Informing other auditors of their responsibilities;
- Reviewing a description of the audit procedures to be performed by the other auditors;
- Directing the other auditors to provide specific documentation;
- Obtaining from the other auditors a written report describing the other auditor's procedures, findings, conclusions, and if applicable, opinion; and
- Reviewing the results of the work of the other auditors.

The proposed amendments are designed to improve the effectiveness of the lead auditor's supervision of the work of other auditors, which in turn should increase the likelihood that the auditors identify material misstatements in the financial statements. The proposed amendments would supplement existing requirements in AS 1201.05, providing more specific direction for applying the general supervisory procedures to the

supervision of other auditors. The following discusses the proposed supervision requirements in more detail.

**1. Informing Other Auditors of Their Responsibilities**

*See proposed paragraph .B2a of AS 1201*

Currently, AS 1201 requires informing engagement team members of their responsibilities, including the objectives of their assigned procedures, details about the procedures to be performed, and other matters that could affect their assignment. AS 1205 does not include a specific requirement<sup>41</sup> for the lead auditor ("principal auditor," as used in the terminology of AS 1205) to inform other auditors of their responsibilities.

The lead auditor, as the auditor issuing the audit report, necessarily has the ultimate responsibility for the overall scope of the audit, including the determination of materiality, risk assessments, and overall audit plan for responding to the assessed risks. This includes determining the locations or business units at which audit procedures are performed. To promote proper supervision of other auditors, the Board's proposal would require the lead auditor to inform the other auditors of the following in writing:

- The scope of work to be performed (e.g., location or business unit at which work is to be performed<sup>42</sup> and the general type of work to be performed, which could range from a few specified audit procedures to a standalone audit); and
- Tolerable misstatement for the location or business unit, identified risks of material misstatement associated with the location or business unit, and, if

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<sup>41</sup> According to AS 1205.12, the principal auditor should consider, among other things, reviewing the audit programs of the other auditor and issuing instructions to the other auditor.

<sup>42</sup> As discussed previously, in multi-location engagements that involve other auditors, the lead auditor would be required to determine locations or business units at which audit procedures should be performed.

determined, the amount below which misstatements are clearly trivial and do not need to be accumulated.<sup>43</sup>

*Comparison with Standards of Other Standard Setters*

Paragraph 40 of ISA 600 includes provisions regarding the group engagement team's communication of requirements to the component auditor. This communication sets out the work to be performed and includes communication requirements in the areas of materiality and significant risks of material misstatement.

AU-C Section 600 contains requirements that are similar to those in ISA 600.

**2. *Reviewing a Description of the Audit Procedures to Be Performed by the Other Auditor***

*See proposed paragraph .B2b of AS 1201*

Existing PCAOB standards require the auditor to develop and document an audit plan that includes a description of, among other things: (i) the planned nature, timing, and extent of the risk assessment procedures and (ii) the planned nature, timing, and extent of tests of controls and substantive procedures.<sup>44</sup> In addition, in situations governed by AS 1201, the auditor is required to inform engagement team members of their responsibilities, including the nature, timing, and extent of procedures they are to perform.<sup>45</sup> In situations governed by AS 1205, the lead auditor ("principal auditor," as used in the terminology of AS 1205) should consider reviewing the audit programs of the other auditor.<sup>46</sup>

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<sup>43</sup> Paragraphs .10-.11 of AS 2810, *Evaluating Audit Results*, require auditors to accumulate misstatements identified during the audit, other than those that are clearly trivial, and provides that auditors may designate an amount pursuant to the standard below which misstatements are trivial and do not need to be accumulated. The proposed requirement indicates that the lead auditor makes the determination of the clearly trivial threshold under AS 2810, if such a threshold is determined.

<sup>44</sup> AS 2101.10.

<sup>45</sup> AS 1201.05a.(2).

<sup>46</sup> AS 1205.12.

To promote proper supervision of other auditors and proper coordination of the overall work to be performed on the audit, the Board's proposal would require the lead auditor to obtain and review the other auditor's description of the nature, timing, and extent of audit procedures to be performed pursuant to the scope of the work communicated in accordance with proposed AS 1201.B2a(1). Based on its review, the lead auditor would be required to determine whether any changes to the other auditor's planned procedures were necessary and, if so, discuss such changes with the other auditor and communicate them in writing to the other auditor.

The proposed requirement provides the flexibility for other auditors – who may be more familiar with the circumstances at the location or business unit where they would work – to design the detailed procedures for the scope of work they are instructed to perform and the associated risks of material misstatement, subject to the lead auditor's review and approval. On the other hand, the other auditors might not always be best suited to design the detailed procedures to be performed. This may be the case if the other auditors are unfamiliar with the location or business unit or lack experience addressing certain unique risks present at the location or business unit. Thus, the proposal provides that, in some situations, it may be necessary for the lead auditor – rather than the other auditor – to determine the nature, timing, and extent of the other auditor's work.

#### *Comparison with Standards of Other Standard Setters*

Paragraph 24 of ISA 600 states that the group engagement team shall determine the type of work to be performed by the group engagement team, or the component auditors on its behalf, on the financial information of the components.

Paragraph 30 of ISA 600 requires, among other things, that the group engagement team be involved in a component auditor's risk assessment if the component auditor performs an audit of the financial information of a significant component. The nature, timing, and extent of this involvement shall include:

- Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error; and
- Reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements. Such documentation may take the form of a memorandum that reflects the

component auditor's conclusion with regard to the identified significant risks.

Further, paragraph 31 states, if significant risks of material misstatement of the group financial statements have been identified in a component on which a component auditor performs the work, the group engagement team shall evaluate the appropriateness of the further audit procedures to be performed to respond to the identified significant risks of material misstatement of the group financial statements. Based on its understanding of the component auditor, the group engagement team shall determine whether it is necessary to be involved in the further audit procedures.

AU-C Section 600 contains requirements that are similar to those in ISA 600.

### ***3. Directing the Other Auditors to Provide Specific Documentation***

*See proposed paragraph .B2c of AS 1201*

Supervision under PCAOB standards necessarily involves review of the work performed. Under the proposal, the lead auditor would be required to determine the necessary extent of its review of documentation of the other auditor's work and communicate to the other auditor in writing the documents that the other auditor should provide for the lead auditor's review (as discussed in more detail below in this appendix). Currently, AS 1215.19 describes documentation of the other auditor's work that the office issuing the auditor's report must obtain, review, and retain. Depending on the extent of supervision determined by the lead auditor pursuant to AS 1201.06, the lead auditor would determine the extent of the additional review of other auditors' work papers necessary to satisfy the requirements of AS 1201. For example, the lead auditor could determine it necessary to request additional documentation for review with respect to the work performed by less experienced other auditors, or with respect to an area of heightened risk of material misstatement. Pursuant to proposed paragraph AS 1201.B2c, the lead auditor would communicate to other auditors the documentation the lead auditor intends to review. For example, the lead auditor can specify individual documents, types of documents, or audit areas that it intends to review.

#### *Comparison with Standards of Other Standard Setters*

As previously mentioned, paragraph 40 of ISA 600 includes provisions regarding the group engagement team's communication of requirements to the component

auditor. This communication includes the form and content of the component auditor's communication with the group engagement team.

Paragraph 42 indicates that the group engagement team is required to evaluate the component auditor's communication and to (a) discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate; and (b) determine whether it is necessary to review other relevant parts of the component auditor's audit documentation.

AU-C Section 600 contains requirements that are similar to those in ISA 600.

#### **4. *Obtaining the Other Auditor's Written Report***

*See proposed paragraph .B2d of AS 1201*

AS 1205 is premised on the lead auditor's use of the work and report of the other auditor, implicitly requiring the lead auditor to obtain that report regardless of whether the auditor makes reference or divides responsibility. The proposed amendments would make the requirement more explicit and extend to all situations in which other auditors are supervised under AS 1201. Specifically, the proposal would require the lead auditor to obtain from the other auditor a written report describing the other auditor's procedures, findings, conclusions, and if applicable, opinion.

This proposed requirement is intended to make sure that the lead auditor is appropriately informed about the work performed by the other auditor and the results of that work. It also should reinforce to other auditors their responsibility to plan and perform their work with due care, complying with PCAOB standards. The notion of other auditor accountability is not new. AS 1205.03 (which would be superseded by the proposal) states that "regardless of the principal auditor's decision [to assume the responsibility for the other auditor's work or divide the responsibility for the audit with the other auditor] the other auditor remains responsible for the performance of his own work and for his own report." While other auditors have obligations with respect to their work, those obligations do not diminish the engagement partner's overall responsibility for the engagement and its performance.<sup>47</sup>

The proposed requirement to obtain a report from the other auditor is generally consistent with existing auditing practice. Observations from the Board's oversight

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<sup>47</sup> See, e.g., AS 1201.03 and AS 2101.03.

activities indicate that many accounting firms have developed firm-specific guidance for written communication to the lead auditor of the results of work performed on the audit by other firms. Such communication can vary from a targeted reporting on specified audit procedures (e.g., inventory observation) to an audit report on the financial statements of a company's subsidiary.

*Comparison with Standards of Other Standard Setters*

Paragraph 41 of ISA 600 states that the group engagement team shall request the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit and that such communication shall include, among other things, the component auditor's overall findings, conclusions or opinion.

AU-C Section 600 contains requirements that are similar to those in ISA 600.

**5. *Reviewing the Results of the Other Auditor's Work***

*See proposed paragraph .B2e of AS 1201*

Under AS 1201.05c, the auditor should review the work of engagement team members to evaluate whether: (i) the work was performed and documented; (ii) the objectives of the procedures were achieved; and (iii) the results of the work support the conclusions reached.<sup>48</sup> In situations governed by AS 1205.12, the lead auditor ("principal auditor," as used in the terminology of AS 1205) must obtain, review, and retain certain documentation prepared by the other auditors, and should consider performing a number of additional review procedures.

In conjunction with the lead auditor's review of the work performed by other auditors pursuant to AS 1201.05c, the proposal would require the lead auditor to determine: (i) whether the other auditor complied with the written communications received and (ii) whether additional audit evidence should be obtained with respect to the work performed by the other auditor.

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<sup>48</sup> Additionally, AS 1201.05b requires the engagement partner or other supervisors to direct engagement team members to bring significant accounting and auditing issues to their attention so they can evaluate those issues and determine that appropriate actions are taken in accordance with PCAOB standards. That requirement also would apply in the supervision of other auditors.

The proposed requirements are designed to be scalable for all situations that involve other auditors. For example, the Board's proposal would not require that the lead auditor review all of the other auditor's work papers to determine whether the other auditor performed its work as requested by the lead auditor. Instead, the lead auditor's determination should be based on: (i) the review of documentation that the lead auditor requested from the other auditor; (ii) the review of the other auditor's written report describing the other auditor's procedures, findings, conclusions, and if applicable, opinion; and (iii) discussions with the other auditor and other information obtained during the audit. Consistent with existing standards, the extent of the lead auditor's review should be determined based on requirements of AS 1201. For example, the higher the likelihood of the risk of material misstatement associated with the areas in which other auditors perform audit procedures, the greater should be the extent of the lead auditor's supervision of the other auditors' work.

The proposed requirement to determine whether additional evidence is needed is intended to address situations in which, for example, the lead auditor determines that the other auditor did not perform the procedures as instructed or sufficient appropriate audit evidence was not obtained with respect to the amounts and disclosures audited by the other auditor. If the other auditor did not perform auditing procedures in accordance with PCAOB standards, the lead auditor would need to determine whether additional procedures should be performed to achieve its objectives in the audit. In another example, the lead auditor's review of the other auditor's work could identify a previously unidentified risk of material misstatement. Under the Board's proposal, the lead auditor would be required to determine the appropriate audit response to the risk.<sup>49</sup>

#### *Comparison with Standards of Other Standard Setters*

Paragraph 44 of ISA 600 states that the group engagement team shall evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by the group engagement team and the component auditors on the financial information of the components, on which the group audit opinion will be based. Paragraph 42 of ISA 600 also states that the group engagement team shall evaluate the component auditor's communication and determine whether it is necessary to review other relevant parts of the component auditor's audit documentation.

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See AS 2810.35 and .36, and proposed AS 1201.B2d.

Paragraph 43 of ISA 600 states that, if the group engagement team concludes that the work of the component auditor is insufficient, the group engagement team shall determine what additional procedures are to be performed and whether they are to be performed by the component auditor or by the group engagement team.

AU-C Section 600 contains requirements that are similar to those in ISA 600.

**C. Supervision of the Other Auditor's Work in a Multi-tiered Audit that Involves Other Auditors**

*See proposed paragraph .B3 of AS 1201*

In some audits that involve other auditors, the engagement team may be organized in a multi-tiered structure ("multi-tiered audit") in which an other auditor audits the financial information of a location or business unit that includes the financial information of a sub-location or sub-unit audited by a second other auditor or assists the lead auditor in supervising the second other auditor. For example, in an audit of a U.S. multinational corporation that consolidates the results of its European operations in the U.K., the engagement team might consist of a U.S. firm as lead auditor, a U.K. auditor for the European operations, and a second other auditor who audits a business unit in Germany that is consolidated into the European operations audited by the U.K. firm. As another example, the lead auditor might ask an other auditor to assist in the supervision of a second other auditor.

The Board's proposed requirements for the supervision of other auditors are designed to be scalable for multi-tiered audits. Specifically, the proposal allows the lead auditor to direct an other auditor to perform certain supervisory procedures with respect to a second other auditor on behalf of the lead auditor, if appropriate. The determination of whether it is appropriate for the first other auditor to act in this capacity would be based on the existing factors for determining the extent of supervision in AS 1201.06. For example, the lead auditor may determine that it would supervise the second other auditor directly if the first other auditor's knowledge of a particular industry is insufficient to effectively review the second other auditor's work. Additionally, it may be more appropriate for the lead auditor to supervise the second other auditor directly because of the nature and significance of the risks associated with the location or business unit at which the second other auditor performs audit procedures, for example, if the company's highest risk transactions were initiated and recorded at that business unit.

Under the proposal, in a multi-tiered audit, the lead auditor would be responsible for the supervision of the entire audit, including the supervision of all other auditors. The lead auditor also would be responsible under the proposal for directly communicating to all the other auditors the scope of the work to be performed, tolerable misstatement, identified risks of material misstatement, and , if determined, the amount below which misstatements are clearly trivial and do not need to be accumulated. If a first other auditor performs supervisory activities with respect to a second other auditor, the lead auditor would be required to evaluate the first other auditor's supervision of the second other auditor's work.

When evaluating the first other auditor's supervision of the second other auditor's work, the lead auditor would not be expected to reperform the first other auditor's supervisory activities. Instead the lead auditor would be expected to take steps to determine that the first other auditor properly performed the assigned supervisory activities, there was proper coordination of the work of the first and second other auditors, as applicable, and significant matters arising during the audit were properly addressed. Such steps may include holding discussions with the first other auditor, and reviewing the other auditors' audit plans, written reports, or other documentation. The extent of the lead auditor's evaluation would depend on the nature of the work performed by the second other auditor, the results of the work, and the necessary extent of the lead auditor's supervision of the first other auditor's work.

The proposal would not change the requirements of AS 1215.19 for the office of the firm issuing the auditor's report to obtain, review, and retain certain documentation supporting the work performed by other auditors. In a multi-tiered audit, the office issuing the auditor's report would be required to obtain, review, and retain the specified documentation prepared by the first other auditor and second other auditor.

The proposed requirements for the supervision of the other auditor's work in a multi-tiered audit that involve other auditors would also apply to audits in which there are multiple second other auditors.

*Comparison with Standards of Other Standard Setters*

The IAASB and ASB do not have analogous requirements.

*Questions:*

31. 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?
32. 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?
33. 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?
34. 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?
35. 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?
36. 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?

37. 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?
38. 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?
39. 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?
40. 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?

**V. Proposed Amendments to AS 1215**

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

Existing PCAOB standards require the engagement partner and other engagement team members assisting with supervisory responsibilities to review the work of engagement team members to evaluate whether: (i) the work was performed and documented; (ii) the objectives of the procedures were achieved; and (iii) the results of the work support the conclusions reached.<sup>50</sup> In multi-location engagements, this review may include audit documentation that is retained outside the office issuing the auditor's report or even outside the lead auditor's firm.

The proposed amendments include a requirement in proposed paragraph .19A of AS 1215 that is designed to provide additional information about reviews performed by

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<sup>50</sup> AS 1201.05c.

the lead auditor of the working papers of other auditors that were not retained. According to this proposed requirement, such information must include a description of the work papers reviewed, the reviewer, and the date of such review (consistent with the existing requirement in AS 1215.06b).

For example, other auditors could perform audit procedures with respect to a company's foreign subsidiary. A senior team member of the lead auditor (for example, a partner or senior manager) could travel to and review the other auditor's working papers in the other auditor's office that is located in the same country as the company's subsidiary.<sup>51</sup> If there are restrictions on the transfer of the other auditor's documentation from the country of the company's subsidiary to the country of the lead auditor, a list of documents (including a description of documents) supporting the work performed by the other auditor with respect to the company's foreign subsidiary that were reviewed by the senior manager would allow the engagement partner in the office issuing the auditor's report (or other internal and external reviewers) to determine, for example, the extent of the senior manager's review of the documents located in the other auditor's office. This does not substantively affect the requirements in AS 1215.18-.19, which are discussed below.

The Board considered an alternative requirement for the lead auditor to make a list of all documents in the other auditor's files, including those not reviewed by the lead auditor. Requiring the lead auditor to compile a list of all the audit documentation of all the other auditors participating in the audit could be burdensome, especially on larger audit engagements. The Board is seeking comment on whether this alternative requirement is preferable to the requirement in the proposed amendments.

## **B. Proposed Amendments to AS 1215 Related to Terminology**

*See proposed amendments for AS 1215*

Because the proposed amendments would define the term "other auditors" in AS 1201 and supersede AS 1205, the proposed amendments would make conforming changes to AS 1215.18 and .19.

Currently, AS 1215.18 requires, among other things, that audit documentation supporting the "work performed by other auditors (including auditors associated with

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<sup>51</sup> In all cases, audit documentation supporting the work of the other firm must be accessible to the office issuing the auditor's report. See AS 1215.18.

other offices of the firm, affiliated firms, or non-affiliated firms) must be retained by or be accessible to the office issuing the auditor's report." AS 1215.19 currently requires that the office issuing the auditor's report obtain, and review and retain, prior to the report release date, certain documentation related to the "work performed by other auditors (including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms)."<sup>52</sup> The proposed amendments to each paragraph revise the paragraphs to delete the parenthetical phrases and revise the language to talk about documentation of the "work performed by other offices of the firm and other auditors," citing the proposed definition of "other auditor" in the amendments to AS 1201.

Further, the proposed amendments would delete a clarifying sentence at the end of AS 1215.19 which currently states, "[i]f the auditor decides to make reference in his or her report to the audit of the other auditor, however, the auditor issuing the report need not perform the procedures in this paragraph and, instead, should refer to AS 1205, *Part of the Audit Performed by Other Independent Auditors*." This clarification is no longer needed because AS 1205 would be superseded and the proposed standard on divided responsibility uses the term "referred-to auditor" instead of "other auditor."

### **C. Comparison with Standards of Other Standard Setters**

The IAASB and ASB do not have requirements analogous to the proposed requirements described in Section A above. As it pertains to Section B, paragraph 41 of ISA 600 states that the group engagement team shall request the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit. The standard requires the communication to include, among others: (a) whether the component auditor has complied with the group engagement team's requirements; (b) information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group financial statements; (c) a list of uncorrected misstatements of the financial information of the component; (d) description of significant deficiencies in internal control at the component level; (e) any other matters that may be relevant to the group audit or that the component auditor wishes to draw to the attention of the group engagement team; and (f) the component auditor's overall findings, conclusions or opinion.

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<sup>52</sup> For audits that involve other auditors, proposed Appendix B of AS 1201 sets forth the requirements for the lead auditor's review of the documentation of other auditors' work. This includes but is not limited to the documents listed in AS 1215.19.

*Questions:*

41. 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?
42. 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?
43. 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, e.g., (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?
44. 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?

**VI. Proposed Amendment to AS 1220**

*See proposed amendment to paragraph .10a of AS 1220*

Under existing PCAOB standards, the engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in

preparing the engagement report.<sup>53</sup> The Board's proposal includes an amendment to AS 1220, which would specifically require the engagement quality reviewer, in an audit involving "other auditors" or "referred-to auditors" (as proposed to be defined), to evaluate the engagement partner's determination that 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 and, if applicable, internal control over financial reporting. (The corresponding proposed requirement for the engagement partner is described in proposed AS 2101.B2.)

*Comparison with Standards of Other Standard Setters*

The IAASB and ASB do not have analogous requirements.

*Questions:*

45. 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?
46. 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)?

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

Currently, situations in which the auditor divides responsibility for the audit with another accounting firm are governed by AS 1205.<sup>54</sup> The Board's proposal would supersede AS 1205 and retain, with certain modifications, the relevant requirements for the divided-responsibility scenario in a proposed new standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*.

The proposed new standard, similar to AS 1205, would apply in situations in which the lead auditor divides responsibility for an audit with another public accounting firm ("referred-to auditor," as discussed in Section II.C). Consistent with AS 1205, the proposed new standard would not require the lead auditor to supervise the work of the

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<sup>53</sup> AS 1220.09.

<sup>54</sup> As discussed above, AS 1205 also includes requirements for audits in which the auditor assumes responsibility for the work of another firm.

referred-to auditor; rather, each auditor is required to supervise its respective engagement team members in accordance with AS 1201. The proposed new standard would not change the auditor's responsibilities with respect to other standards of the PCAOB. For example, both the lead auditor and referred-to auditor would be required to comply with PCAOB standards when scoping their respective audits and making materiality determinations.<sup>55</sup>

In general, the proposed new standard would establish certain requirements for the lead auditor that would be based on provisions in AS 1205. These proposed requirements would require the lead auditor to:

- Perform procedures with respect to the audit of the referred-to auditor;
- Obtain a representation from the referred-to auditor regarding the referred-to auditor's compliance with independence and ethics requirements of the PCAOB and the SEC;
- Determine, based on inquiries made to the referred-to auditor and other information obtained by the lead auditor during the audit, that the referred-to auditor knows the relevant requirements of the applicable financial reporting framework, standards of the PCAOB, and financial reporting requirements of the SEC; and
- Disclose in the lead auditor's report: (i) the division of responsibility between the lead auditor and referred-to auditor, and (ii) the magnitude of the portions of the company's financial statements audited by the auditors.

The proposed new standard would provide the following new terms and requirements:

- New terms "lead auditor" (same as the proposed term in AS 1201) and "referred-to auditor;"
- Obtaining a representation from the referred-to auditor that the referred-to auditor is duly licensed to practice under the laws of the jurisdiction that apply to the referred-to auditor's work;

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<sup>55</sup> See, e.g., AS 2101.11–.14, and AS 2105.10.

- If the referred-to auditor would play a substantial role in the preparation or furnishing of the lead auditor's report, determining whether the referred-to auditor is registered pursuant to the rules of the PCAOB;
- Communicating the decision to divide responsibility for the audit with another public accounting firm and determining a course of action when the lead auditor is unable to divide responsibility; and
- Disclosing the name of the referred-to auditor in the lead auditor's report.

Consistent with AS 1205, in the divided-responsibility scenario, the proposed amendments would require that the engagement partner determine sufficiency of his or her firm's participation in the audit to serve as the lead auditor. As discussed above, the proposed amendments would incorporate into the Board's standard on planning the existing requirements for determining sufficiency of the firm's participation from AS 1205 (which would be superseded by the proposal), with certain modifications.

The remainder of this section details key provisions of the proposed new standard and disposition of certain existing requirements of AS 1205. The discussion is organized as follows:

	<u>Subsection</u>	<u>Page</u>
VII.A	Terminology and Objectives	A4-47
VII.B	Performing Procedures with Respect to the Audit of the Referred-to Auditor	A4-49
VII.C.	Making Reference in the Lead Auditor's Report to the Audit and Auditor's Report of the Referred-to Auditor	A4-55

#### **A. Terminology and Objectives**

*See proposed paragraphs .02 and .A2 – .A3 of AS 1206 in Appendix 2*

Currently, AS 1205 uses terms "principal auditor" and "other auditor" when referring to the auditor issuing the auditor's report on the consolidated financial statements (principal auditor) and the accounting firm for whose work the principal auditor assumes responsibility or to whose audit and report the principal auditor makes reference in the principal auditor's report (other auditor). Since proposed AS 1206 would apply to only to situations in which the auditor divides responsibility with another public

accounting firm, the proposed standard would use and define the term "referred-to auditor" to distinguish the firms with which the lead auditor divides responsibility from the "other auditors" that would be supervised under AS 1201, as proposed to be amended.

Under the proposed new standard, the objectives of the lead auditor would be to:

- (i) communicate with the referred-to auditor and determine that audit procedures are properly performed, in coordination with the referred-to auditor, with respect to the consolidation or combination of accounts in the company's financial statements and
- (ii) make the necessary disclosures in the lead auditor's report. The proposed new standard would not change the lead auditor's or referred-to auditor's responsibilities under other PCAOB standards. Both the lead auditor and referred-to auditor are required to plan and perform their respective audits and issue audit opinions in accordance with PCAOB standards.

*Comparison with Standards of Other Standard Setters*

IAASB standards do not provide for an auditor to divide responsibility for the audit with another independent public accounting firm. Paragraph 11 of ISA 600 states that the auditor's report on the group financial statements shall not refer to a component auditor, unless required by law or regulation.

According to paragraph .08 of AU-C Section 600, certain requirements of AU-C Section 600 apply only when the auditor of the group financial statements is assuming responsibility for the work of component auditors. All other requirements in AU-C Section 600 apply to all audits of group financial statements.

Paragraph .25 of AU-C Section 600 does not allow for the reference to the audit of a component auditor in the auditor's report on the group financial statements unless:

- a. The group engagement partner has determined that the component auditor has performed an audit of the financial statements of the component in accordance with the relevant requirements of generally accepted auditing standards ("GAAS"); and
- b. The component auditor has issued an auditor's report that is not restricted as to use.

Unlike the requirements of the proposed AS 1206, paragraph .28d of AU-C Section 600 describes making reference to the audit of a component auditor in the

auditor's report on the group financial statements when the component auditor's report does not state that the audit of the component's financial statements was prepared in accordance with GAAS or PCAOB standards.

**B. Performing Procedures with Respect to the Audit of the Referred-to Auditor**

**1. Performing Procedures Regarding the Consolidation or Combination of the Financial Statements**

*See proposed paragraph .03 of AS 1206*

Currently, AS 1205.10 requires that the principal auditor adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.

The proposed new standard would retain and strengthen the existing requirement. Under the proposal, the lead auditor would be required to determine that audit procedures are performed, in coordination with the referred-to auditor, to test and evaluate the consolidation or combination of the financial statements of the business units audited by the referred-to auditor into the company's financial statements. Matters affecting the consolidation or combination of the financial statements would typically include items that are not in the scope of the referred-to auditor's audit, for example, elimination of intercompany transactions with the business unit audited by the referred-to auditor.

**2. Communicating the Plan to Divide Responsibility**

*See proposed paragraph .04 of AS 1206*

To enhance the communication between the lead auditor and the referred-to auditor, the proposed new standard would establish a specific requirement to communicate to the referred-to auditor, in writing, the lead auditor's decision to divide responsibility for the audit with the referred-to auditor pursuant to the proposed new standard and other applicable PCAOB standards. Having been informed of the lead auditor's decision, the referred-to auditor would be able to take the necessary steps to ascertain the implications of participating in the audit of the company. For example,

SEC rules require that the audit report prepared by the referred-to auditor be filed with the SEC.<sup>56</sup>

**3. *Requesting a Written Representation Regarding Independence and Licensing***

*See proposed paragraph .05 of AS 1206*

Currently, paragraph .06b of AS 2101 requires the auditor to determine compliance with independence and ethics requirements. In addition, for situations governed by AS 1205, paragraph .10 of AS 1205 requires the lead auditor ("principal auditor," as used in the terminology of AS 1205) to make inquiries concerning the other auditor's independence. According to AS 1205.10 these inquiries may include procedures such as obtaining a representation from the other auditor that the other auditor is independent.<sup>57</sup>

Under PCAOB Rule 3520, *Auditor Independence*, all auditors involved in the audit (including the firm and personnel of the lead auditor and other auditors), must be independent of the audit client throughout the audit and professional engagement period. This requirement for the lead auditor and other auditors not only extends to the independence rules and standards of the PCAOB but also extends to the rules and regulations of the SEC under the federal securities laws.

The proposed new standard would strengthen the existing requirements in AS 1205 regarding the lead auditor's responsibilities with respect to the independence of the referred-to auditor. Specifically, the lead auditor would be required to request a written representation from the referred-to auditor that the referred-to auditor is in compliance with the independence and ethics requirements of the PCAOB and the SEC. AS 1205 does not address situations in which the other auditor (proposed term "referred-to auditor") is not licensed to issue an audit report in their country or to perform audit work in other countries. The proposed new standard would add a requirement for the lead auditor to verify, by written representation from the referred-to auditor, that the referred-to auditor is duly licensed to practice under the laws of the jurisdiction that apply to the work of the referred-to auditor.

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<sup>56</sup> See Regulation S-X Rule 2-05.

<sup>57</sup> See AS 1205.10b.

In certain situations, the lead auditor would be precluded from dividing responsibility with the referred-to auditor based on the information about the referred-to auditor's independence and licensing, as discussed below.

**4. Conditions That Should Be Met for the Lead Auditor to Divide Responsibility**

Under the existing provisions of AS 1205.11, the principal auditor should appropriately qualify or disclaim his or her opinion on the consolidated financial statements if the results of the principal auditor's work performed in accordance with AS 1205 lead the principal auditor to the conclusion that he or she can neither assume responsibility for the work of the other auditor nor divide responsibility for the audit with the other auditor.

The proposed new standard would describe, more specifically than AS 1205: (i) conditions that should be met for the lead auditor to divide responsibility with the referred-to auditor and (ii) the lead auditor's course of action when the lead auditor is unable to divide responsibility. The proposed requirements are designed to facilitate compliance with the ethics and independence requirements of the PCAOB and the SEC and with the Board's registration rules and to reduce the likelihood of filing with the SEC auditor's reports that violate any relevant local licensing requirements. These requirements are detailed below.

**(i) Performed an Audit and Issued an Auditor's Report in Accordance with PCAOB Standards**

*See proposed paragraph .06a of AS 1206*

According to paragraph .06a in the proposed new standard, the lead auditor may divide responsibility with another accounting firm only if the referred-to auditor has represented that it has performed an audit and issued an auditor's report in accordance with PCAOB standards.<sup>58</sup> This proposed provision, which is not included in AS 1205, is

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<sup>58</sup> AS 3101 applies to auditors' reports issued in connection with audits of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with the applicable financial reporting framework. AS 2201 applies to auditors' reports issued in connection with audits of management's assessment of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements.

consistent with the existing SEC rules and guidance with respect to auditors' reports filed with the SEC.<sup>59</sup>

**(ii) Financial Reporting Framework Used to Prepare the Company's and Business Unit's Financial Statements**

*See proposed paragraph .06b of AS1206*

According to paragraph .06b in the proposed new standard, the lead auditor may divide responsibility with another accounting firm only if 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. This proposed provision, which is not included in AS 1205, is consistent with the notion that the amounts in the financial statements reported on by the referred-to auditor are included without adjustment in the financial statements reported on by the lead auditor.

**(iii) Knowledge of Relevant Requirements and Standards**

*See proposed paragraph .06c of AS 1206*

Under the proposed new standard the lead auditor may divide responsibility with the referred-to auditor only if the lead auditor determines, based on inquiries made to the referred-to auditor and other information obtained by the lead auditor during the audit, that the referred-to auditor knows (*i.e.*, individuals who conduct the audit know) the relevant requirements of the applicable financial reporting framework, standards of the PCAOB, and financial reporting requirements of the SEC. Similar requirements are proposed in paragraph .B6 of AS 2101 and discussed in Section III.E.

Under the proposed new standard, for example, the lead auditor could interact with the referred-to auditor (*e.g.*, a teleconference) to discuss the referred-to auditor's prior and current work experience that may be relevant to evaluating the professional competence in the context of the engagement.

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<sup>59</sup> See Regulation S-X Rule 2-02(b)(1) and SEC Release No. 34-49708, *Commission Guidance Regarding the Public Company Accounting Oversight Board's Auditing and Related Professional Practice Standard No. 1*.

**(iv) Ethics and Independence, Licensing, and Registration**

*See proposed paragraphs .06d(1), .06d(2), and .06e of AS 1206*

Under the proposed new standard the lead auditor may divide responsibility with the referred-to auditor only if certain conditions are met regarding the referred-to auditor's: (i) compliance with ethics and independence requirements of the PCAOB and the SEC; (ii) licensing status under the laws of the jurisdiction of the referred-to auditor's principal office; and (iii) registration status with the PCAOB, when applicable. The proposed requirements are designed to increase the likelihood that the lead auditor divides responsibility with an appropriately qualified referred-to auditor.

**(v) Lead Auditor's Course of Action**

*See proposed paragraph .07 of AS 1206*

The proposed new standard also would describe, more specifically than AS 1205, the options available to the lead auditor in situations in which the lead auditor is unable to divide responsibility. According to the proposed new standard, the options available to the lead auditor in such situations are:

- Planning and performing procedures with respect to the portion of the company's financial statements covered by the other accounting firm's report that are necessary for the lead auditor to issue an opinion on the company's financial statements and, if applicable, internal control over financial reporting; or
- Qualifying or disclaiming the lead auditor's report (an option that is currently described in AS 1205); or
- Withdrawing from the engagement.

Similar to AS 1205, the proposed new standard would require the lead auditor to state the reasons for modifying the report and, when expressing a qualified opinion, disclose the magnitude of the portion of the company's financial statements to which the lead auditor's qualification extends.

## **5. Comparison with Standards of Other Standard Setters**

IAASB standards do not contain requirements for situations in which the auditor divides responsibility for the audit with another independent public accounting firm.

Paragraph .41 of AU-C Section 600 states that the group engagement team should communicate its requirements to a component auditor on a timely basis and that this communication should include, among other things, a request that the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, confirm that the component auditor will cooperate with the group engagement team.

According to paragraph .22 of AU-C Section 600, the group engagement team should obtain an understanding of, among other things, whether a component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent.

Paragraph .23 of AU-C Section 600 states that, when a component auditor does not meet the independence requirements that are relevant to the group audit or the group engagement team has serious concerns about the other matters listed in paragraphs .22a–b of AU-C Section 600 (which are related to a component auditor's qualifications), the group engagement team should obtain sufficient appropriate audit evidence relating to the financial information of the component without making reference to the audit of that component auditor in the auditor's report on the group financial statements or otherwise using the work of that component auditor.

Paragraph .28 of AU-C Section 600 addresses situations in which an auditor's report on group financial statements makes reference to a component auditor when (1) the component's financial statements are prepared using a different financial reporting framework from that used for the group financial statements; or (2) the component auditor's work was performed under different auditing standards, and additional procedures are required to comply with GAAS.

### *Questions:*

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

48. 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?
49. 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?
50. 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?
51. 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?

**C. Making Reference in the Lead Auditor's Report to the Audit and Auditor's Report of the Referred-to Auditor**

*See proposed paragraphs .08, 09, and .B1 of AS 1206*

**1. Requirements for Making Reference**

Paragraphs .08 and .09 of the proposed new standard would establish requirements for making reference in the lead auditor's report to the audit and auditor's report of the referred-to auditor in situations in which the responsibility for the audit is divided. Some of the proposed requirements should be familiar to auditors because they are based on the existing requirements in AS 1205. For example, similar to AS 1205, the proposed new standard would require that the lead auditor's report:

- Indicate clearly, in the introductory, scope, and opinion paragraphs, the division of responsibility between the portion of the company's financial

statements and, if applicable, internal control over financial reporting, covered by the lead auditor's own audit and that covered by the audit of the referred-to auditor; and

- 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 (or by each of the referred-to auditors if there is more than one). This may be done by stating the dollar amounts or percentages of total assets, total revenues, and other appropriate criteria necessary to identify the portion of the company's financial statements audited by each of the referred-to auditors.

If the report of the referred-to auditor is other than a standard report, the proposed new standard, similar to AS 1205, would require that the lead auditor make reference to the departure from the standard report and its disposition in the lead auditor's report, unless the matter is clearly trivial to the company's financial statements.

## **2. Identifying the Referred-to Auditor by Name**

To make the name of the referred-to auditor more readily available to investors and other users of the lead auditor's report, the proposed new standard would include a new requirement to identify the referred-to auditor by name in the lead auditor's report. SEC rules already include a requirement that the audit report of the referred-to auditor be filed with the SEC, so the name of the referred-to auditor is already made public.<sup>60</sup> Under AS 1205, the other auditor may be named only with its express permission and if its report is presented together with the lead auditor's report.<sup>61</sup> According to the proposed new standard, the lead auditor's report should identify the referred-to auditor by name and refer to the report of the referred-to auditor when describing the scope of the audit and when expressing an opinion.

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<sup>60</sup> See Rule 2-05 of Regulation S-X, 17 C.F.R. 210.2-05.

<sup>61</sup> See AS 1205.07. The Board amended AS 1205.07 in PCAOB Release No. 2015-008, *Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards* (Dec. 15, 2015), which is subject to approval by the SEC. The amendments remove the requirement for the lead auditor to obtain the other auditor's express permission when deciding to disclose the other auditor's name in the lead auditor's report.

### **3. Comparison with Standards of Other Standard Setters**

IAASB standards do not contain requirements for situations in which the auditor divides responsibility for the audit with another independent public accounting firm.

Paragraph .28 of AU-C Section 600 requires that, when the group engagement partner decides to make reference to the audit of a component auditor in the auditor's report on the group financial statements, the report on the group financial statements clearly indicate, among other things:

- a. That the component was not audited by the auditor of the group financial statements but was audited by the component auditor; and
- b. The magnitude of the portion of the financial statements audited by the component auditor.

Unlike the proposed AS 1206, paragraph .29 of AU-C Section 600 requires that, among other things, if the group engagement partner decides to name a component auditor in the auditor's report on the group financial statements the component auditor's express permission should be obtained.

Paragraph .30 of AU-C Section 600 requires that, if the opinion of a component auditor is modified or if that report includes an emphasis-of-matter or other-matter paragraph, the auditor of the group financial statements determine the effect that this may have on the auditor's report on the group financial statements. When deemed appropriate, the auditor of the group financial statements should modify the opinion on the group financial statements or include an emphasis-of-matter paragraph or an other-matter paragraph in the auditor's report on the group financial statements.

*Question:*

52. 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***

The Board's proposal would supersede AI 10, which provides guidance for the lead auditor ("principal auditor," as used in the terminology of AS 1205) on certain matters involving the use of the work and reports of another accounting firm under AS 1205.<sup>62</sup> Specifically, AI 10 addresses requesting the other accounting firm to perform specific procedures, responding to inquiries made by the accounting firm, and performing procedures when the principal auditor decides not to make reference to the audit of another accounting firm (see interpretations 1, 4, 5, and 6 of AI 10). AI 10 also provides guidance for the other accounting firm with respect to inquiring of the principal auditor as to matters that may be significant to the audit performed by the other accounting firm (see interpretations 2 and 3 of AI 10).

Because AS 1205 would be superseded by the Board's proposal, auditors would be required to follow the direction in AS 1201 in situations in which the lead auditor supervises the work of other auditors. As detailed earlier in this appendix, AS 1201 describes requirements for, among other things, informing engagement team members (including other auditors) of their responsibilities, reviewing their work, and determining the extent of supervision. Further, AS 1215 describes certain specific information that the office issuing the auditor's report is required to obtain, review, and retain with respect to the work performed by other auditors.

Situations in which the lead auditor divides responsibility for the audit with a referred-to auditor would be governed by the proposed new standard. The proposed new standard requires, among other things, that the lead auditor communicate with the referred-to auditor and determine that audit procedures are properly performed, in coordination with the referred-to auditor, with respect to the consolidation or

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<sup>62</sup> Currently, AS 1205 uses the terms "principal auditor" and "other auditor" to describe, respectively, the accounting firm issuing the auditor's report on the company's consolidated financial statements and the accounting firm for whose work the principal auditor assumes responsibility, or with whom the principal auditor divides responsibility, under AS 1205.

combination of the financial statements of the business units audited by the referred-to auditor into the company's financial statements.

The other accounting firm's inquiry of the lead auditor when the lead auditor supervises the work of the other accounting firm is addressed by existing standards. For example, auditors are required to apply due professional care.<sup>63</sup> This includes bringing to the attention of appropriate persons any concerns about significant accounting and auditing issues.<sup>64</sup> For situations in which the lead auditor divides responsibility for the audit with the other accounting firm, a proposed amendment to AS 2110 would carry forward, with modifications, the existing requirement in AI 10 for the referred-to auditor's inquiries of the lead auditor as to matters (e.g., executive compensation arrangements) that may be significant to the referred-to auditor's own audit.

*Question:*

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

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

Currently, in the context of making inquiries about the professional reputation and standing of an auditor whose audit report is used as audit evidence in the audit of a company's financial statement (such as the audit report of a service auditor or predecessor auditor), several existing provisions within PCAOB auditing standards refer to AS 1205.10 through .12 as relevant guidance for making such inquiries.<sup>65</sup> Today, in the majority of these circumstances, the auditor whose report is used in this manner is

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<sup>63</sup> See generally AS 1015.

<sup>64</sup> See, e.g., AS 1201.05b.

<sup>65</sup> See, e.g., paragraph .28 of AS 2503 (currently AU sec 332), *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, paragraphs .18–.19 of AS 2601, *Consideration of an Entity's Use of a Service Organization* (currently AU sec. 324, *Service Organizations*), and footnote 8 to paragraph .12 of AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors* (currently AU sec. 315, *Communications Between Predecessor and Successor Auditors*).

neither supervised by the lead auditor in accordance with AS 1201 nor serving as another independent auditor under AS 1205.<sup>66</sup>

Because the Board's proposal would supersede AS 1205, the other proposed amendments would incorporate the provisions of AS 1205.10 through .12 into the text of the auditing standards that currently refer to it with minor modifications to conform to the specific issue addressed by each provision amended and the Board's proposal generally.

*Question:*

54. 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?

**C. Certain Existing Requirements of AS 1205—Discussion of Remaining Requirements Not Specifically Addressed in the Proposed New Standard**

*Sufficiency of participation.* Currently, for situations in which AS 1205 applies, paragraph .02 of the standard describes requirements for determining the sufficiency of a firm's participation in an audit to serve as lead auditor ("principal auditor," as used in the terminology of AS 1205.) As discussed earlier in this release, under the proposed amendments, the sufficiency determination requirements would be included in Appendix B of AS 2101, and the auditor would be required to apply the requirements when other auditors are involved in the audit, including in situations when the lead auditor divides responsibility for the audit with the referred-to auditor. The proposed new standard would reference the relevant proposed requirements in AS 2101.<sup>67</sup>

*Situations involving reporting under equity and cost methods of accounting.* Currently, AS 1205.14 includes a discussion of whether the auditor is in the position of a principal auditor and whether the auditor may refer to the work and report of the

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<sup>66</sup> For these circumstances the auditor who uses the audit may be in a position analogous to that of a principal auditor. See, e.g., AS 1205.14.

<sup>67</sup> See the first note to paragraph .01 of the proposed new standard.

referred-to auditor in situations in which another auditor performs work and issues a report on the financial statements of a part of the company for which the company accounts under either the equity method or cost method of accounting.

With this proposal, the Board seeks neither to expand or narrow the range of situations involving other auditors currently covered by AS 1205 and AS 1201. Rather, the proposal seeks to update and improve the requirements governing the lead auditor's involvement with other auditors within the existing range of situations covered by those standards.

With respect to investments accounted for under the equity method that are selected for testing pursuant to AS 2101,<sup>68</sup> AS 1201, as proposed to be amended, would apply when the investor's equity in the underlying net assets and its share of the earnings or losses of the investee are recorded based on investee financial statements that are audited by an auditor other than the lead auditor, unless the lead auditor divides responsibility with the auditor of the investee, in which case proposed AS 1206 would apply. This is consistent with the principle currently set forth in AS 1205.14.

*Situations involving pooling-of-interest transactions.* The proposed new standard does not retain the provisions in AS 1205.16 regarding reporting on restated financial statements following a pooling-of-interest transaction because the pooling-of-interest method of accounting is no longer allowed for business combinations under either U.S. generally accepted accounting principles or International Financial Reporting Standards.

## **IX. Additional Questions Regarding Certain Aspects of the Proposal**

Appendix 3 contains additional amendments that the Board is proposing to conform its standards to the proposed amendments to AS 1201, AS 1215, AS 1220, and AS 2101. The proposed conforming amendments are not intended to change the meaning of existing requirements. The Board invites comments on the amendments included in Appendix 3. The following are specific questions on the proposed amendments included in Appendix 3 and more general questions on the overall proposal:

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<sup>68</sup> See AS 2101.11 through .14, which set forth requirements for determining locations or business units at which audit procedures should be performed.

55. Are the proposed conforming amendments in Appendix 3 appropriate and clear? Why or why not? What changes to the amendments are necessary?
56. 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?
57. 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?
58. 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?
59. 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?

## **APPENDIX 5**

### **Characteristics of Self-Identified Emerging Growth Companies**

The PCAOB has been monitoring implementation of the Jumpstart Our Business Startups Act ("JOBS Act") in order to understand the characteristics of EGCs<sup>1</sup> and inform the Board's consideration of whether it should request that the SEC apply the proposed amendments to audits of EGCs. To assist commenters, the Board is providing the following information regarding EGCs that it has compiled from public sources.<sup>2</sup>

As of November 15, 2015, based on the PCAOB's research, there were 2,229 companies that had filed audited financial statements and identified themselves as EGCs in at least one SEC filing. Among the 2,229 EGCs, there were 259 that did not file audited financial statements within the 18 months preceding November 15, 2015.<sup>3</sup>

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<sup>1</sup> Pursuant to the JOBS Act, an EGC is defined in Section 3(a)(80) of the Securities Exchange Act of 1934 ("Exchange Act"). In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than \$1 billion during its most recently completed fiscal year and its first sale of common equity securities pursuant to an effective registration statement under the Securities Act of 1933 ("Securities Act") did not occur on or before December 8, 2011. See JOBS Act Section 101(a), (b), and (d). An issuer retains its EGC status until the earliest of: (i) the first year after it has total annual gross revenue of \$1 billion or more (as indexed for inflation every five years by the SEC); (ii) the end of the fiscal year after the fifth anniversary of its first sale of common equity securities under an effective Securities Act registration statement; (iii) the date on which the company issues more than \$1 billion in non-convertible debt during the prior three year period; or (iv) the date on which it is deemed to be a "large accelerated filer" under the Exchange Act (generally, an entity that has been public for at least one year and has an equity float of at least \$700 million).

<sup>2</sup> The staff of the PCAOB's Office of Research and Analysis identified the population of EGCs using Audit Analytics data on companies that, as of the calculation date, self-identified as EGCs in SEC filings. The data excludes companies that, as of the calculation date, had (i) terminated their Exchange Act registration, (ii) had their Exchange Act registration revoked, or (iii) withdrawn their registration statement before effectiveness and, in each case, did not subsequently file audited financial statements with the SEC. It also excludes companies that reported more than \$1 billion in annual revenues or self-identified as a large accelerated filer. PCAOB staff has not otherwise attempted to validate these companies' self-identification as EGCs.

<sup>3</sup> Approximately 24 percent of these 259 companies are blank check companies according to the Standard Industrial Classification ("SIC") code. This is the most common SIC code among the 259 companies; the next most common SIC code (6 percent) is that for metal mining. The remaining SIC codes each represent less than 5

Because of lack of current data regarding these 259 companies, the information below focuses on the remaining 1,970 companies that filed audited financial statements with the SEC in the 18 months preceding November 15, 2015.

### **General Characteristics**

These companies operate in diverse industries. The five most common SIC codes applicable to these companies are: (i) pharmaceutical preparations; (ii) blank check companies; (iii) real estate investment trusts; (iv) prepackaged software services; and (v) computer processing and data preparation.

The five SIC codes with the highest total assets as a percentage of the total assets of the population of EGCs are codes for: (i) real estate investment trusts; (ii) state commercial banks; (iii) crude petroleum or natural gas; (iv) national commercial banks; and (v) pharmaceutical preparations. Total assets of EGCs in these five SIC codes represent approximately 45 percent of the total assets of the population of EGCs. EGCs in two of these five SIC codes (state commercial banks and national commercial banks) represent financial institutions, and the total assets for these two SIC codes represent approximately 17 percent of the total assets of the population of EGCs.

Approximately 14 percent of the EGCs had identified themselves in Securities Act registration statements and had not reported under the Exchange Act as of November 15, 2015. Approximately 74 percent of EGCs began reporting under the Exchange Act in 2012 or later. The remaining 12 percent of these companies have been reporting under the Exchange Act since 2011 or earlier.

Approximately 56 percent of EGCs that filed an Exchange Act filing indicated that they were smaller reporting companies.<sup>4</sup>

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percent. Approximately 80 percent of these 259 companies had an explanatory paragraph included in the last auditor's report filed with the SEC stating that there is substantial doubt about the company's ability to continue as a going concern. Approximately 10 percent of these 259 companies were audited by firms that were annually inspected firms in 2015 and 90 percent of these 259 companies were audited by firms that are subject to inspection at least every three years by the PCAOB, containing U.S. firms (85 percent), firms that are non-U.S. affiliates of annually inspected firms in 2015 (3 percent), and other non-U.S. firms (2 percent).

<sup>4</sup> The SEC adopted its current smaller reporting company rules in *Smaller Reporting Company Regulatory Relief and Simplification*, Securities Act Release No. 33-8876 (Dec. 19, 2007). Generally, companies qualify to be smaller reporting companies and, therefore, have scaled disclosure requirements if they have less than \$75 million in public equity float. Companies without a calculable public equity float will

Approximately 41 percent (802) of the 1,970 EGCs have common equity securities listed on a U.S. national securities exchange ("publicly listed EGCs").<sup>5</sup> These EGCs represent approximately 16 percent of all publicly listed companies and approximately 1 percent of the total market capitalization of publicly listed companies.

## Financial Data

The information in this section is derived from the most recent audited financial statements filed as of November 15, 2015 for the 1,970 EGCs. The descriptions in this section also include tabular information for all EGCs, EGCs that are not publicly listed ("non-listed EGCs"), and publicly listed EGCs. To enable comparison of publicly listed EGCs with the broader public equity market, the information also includes data about the other publicly listed companies.

**Assets.** The reported assets of all EGCs ranged from zero to approximately \$12.9 billion. The average and median reported assets were approximately \$223 million and \$3.4 million, respectively. Publicly listed EGCs had significantly higher average and median assets (approximately \$468 million and \$141 million, respectively) as compared to non-listed EGCs (approximately \$55 million and \$100,000, respectively). Other publicly listed companies had even higher average and median assets (approximately \$18.5 billion and \$1.3 billion, respectively).

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qualify if their annual revenues were less than \$50 million during the most recently completed fiscal year for which audited financial statements are available. Scaled disclosure requirements generally reduce the compliance burden of smaller reporting companies compared to other issuers.

<sup>5</sup> To compare the publicly listed EGC population with the broader public equity market, the PCAOB compared the data compiled with respect to the population of companies that identified themselves as EGCs with a benchmark derived from data from Standard & Poor's on companies that have at least one class of common equity securities (common-ordinaries, units with a common share component, and depository receipts) listed on a U.S. national securities exchange. The benchmark population is limited to companies that are not investment companies and that, according to Audit Analytics data, have filed audited financial statements with the SEC in the 18 months preceding the calculation date. From a total population of 5,119 such companies, the 802 publicly listed EGCs are excluded to avoid double counting. Using this methodology, PCAOB staff identified 4,317 companies in the benchmark population (referred to as "other publicly listed companies") as of November 15, 2015.

<b>Reported Assets (\$ millions)</b>	<b><u>All EGCs</u></b>	<b><u>Non-listed EGCs</u></b>	<b><u>Publicly Listed EGCs</u></b>	<b><u>Other Publicly Listed Companies</u></b>
Minimum	0	0	0	0
Maximum	12,859.4	12,859.4	9,798.7	2,634,139.0
Average	223.0	54.6	468.3	18,486.8
Median	3.4	0.1	141.4	1,299.2

**Revenues.** The reported revenues ranged from zero to approximately \$926 million. The average and median reported revenue were approximately \$55 million and \$81,000, respectively. Publicly listed EGCs had significantly higher average and median revenues (approximately \$118 million and \$33 million, respectively) as compared to non-listed EGCs (approximately \$12 million and \$0, respectively). Other publicly listed companies had even higher average and median revenues (approximately \$ 5.1 billion and \$580 million, respectively).

<b>Reported Revenues (\$ millions)</b>	<b><u>All EGCs</u></b>	<b><u>Non-listed EGCs</u></b>	<b><u>Publicly Listed EGCs</u></b>	<b><u>Other Publicly Listed Companies</u></b>
Minimum	0	0	0	0
Maximum	926.4	910.2	926.4	485,651.0
Average	54.9	11.5	118.2	5,124.2
Median	0.081	0	33.2	579.6

**Companies Reporting Zero Revenues.** The table below provides information about the percentage of all EGCs and the other categories of companies that reported zero revenues.

	<b><u>All EGCs</u></b>	<b><u>Non-listed EGCs</u></b>	<b><u>Publicly Listed EGCs</u></b>	<b><u>Other Publicly Listed Companies</u></b>
Companies Reporting Zero Revenues	42%	56%	21%	2%

**Companies Reporting Revenues Greater than Zero.** The table below provides information about the percentage of all EGCs and the other categories of companies that reported revenues greater than zero.

	<u>All EGCs</u>	<u>Non-listed EGCs</u>	<u>Publicly Listed EGCs</u>	<u>Other Publicly Listed Companies</u>
Companies Reporting Revenues Greater than Zero	58%	44%	79%	98%

The average reported assets and revenues of EGCs that reported revenues greater than zero were approximately \$371 million and \$94 million, respectively. Publicly listed EGCs had significantly higher average assets and revenues (approximately \$573 million and \$149 million, respectively) as compared to non-listed EGCs (approximately \$121 million and \$26 million, respectively). Other publicly listed companies had even higher average assets and revenues (approximately \$ 18.9 billion and \$5.2 billion, respectively).

<u>Reported Assets and Revenues (\$ millions)</u>	<u>All EGCs</u>	<u>Non-listed EGCs</u>	<u>Publicly Listed EGCs</u>	<u>Other Publicly Listed Companies</u>
<b><u>Assets</u></b>				
Minimum	0	0	0	0
Maximum	12,859.4	12,859.4	9,798.7	2,634,139.0
Average	370.8	121.4	573.3	18,889.6
Median	71.0	1.1	200.8	1,371.7
<b><u>Revenues</u></b>				
Minimum	0.00002	0.00002	0.00391	0.002
Maximum	926.4	910.2	926.4	485,651.0
Average	93.9	25.9	149.0	5,237.0
Median	12.7	0.5	67.2	602.9

## Geographic Segment Reporting

The most recent audited financial statements filed in the 18 months preceding<sup>6</sup> November 15, 2015 for those companies that identified as EGCs indicated that approximately 16 percent of the EGCs reported segment sales and assets<sup>7</sup> in geographic areas outside the country or region of the accounting firm issuing the auditor's report.<sup>8</sup> For these EGCs, on average, 59 percent and 67 percent of the reported segment sales and assets, respectively, were in geographic areas outside the country or region of the accounting firm issuing the auditor's report.<sup>9</sup>

## Management Reporting on ICFR

Generally, EGC management is required to report on the effectiveness of internal control over financial reporting ("ICFR"), although auditor attestation is not required.<sup>10</sup> Approximately 50 percent of the 1,970 EGC companies provided a management report on ICFR. Of those companies that provided a management report, approximately 53 percent stated in the report that the company's ICFR was not effective. Publicly listed EGCs reported material weaknesses at a significantly lower rate (14 percent) as compared to non-listed EGCs (71 percent). Other publicly listed companies reported material weaknesses at an even lower rate (7 percent).

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<sup>6</sup> An additional 259 entities identified as EGCs and did not file audited financial statements within the preceding 18 months.

<sup>7</sup> See FASB Accounting Standards Codification, Topic 280, *Segment Reporting*.

<sup>8</sup> Approximately 50 percent and 40 percent of the population of publicly listed companies that are not EGCs reported segment sales and assets, respectively, in geographic areas outside the country or region of the accounting firm issuing the auditor's report.

<sup>9</sup> For the population of publicly listed companies that are not EGCs that reported segment sales or assets in geographic areas outside the country or region of the accounting firm issuing the auditor's report, approximately 45 percent and 38 percent of those segment sales and assets, respectively, were in geographic areas outside the country or region of the accounting firm issuing the auditor's report.

<sup>10</sup> The management report on ICFR is required in annual reports, starting with the second annual report filed by the company. See Instruction 1 to Item 308(a) of Regulation S-K. EGCs that have not yet filed at least one annual report are therefore not required to provide it. EGCs are exempt from the requirement for auditor attestation of ICFR. See Section 404(b) of the Sarbanes-Oxley Act.

<b><u>ICFR Reporting</u></b>	<b><u>All EGCs</u></b>	<b><u>Non-listed EGCs</u></b>	<b><u>Publicly Listed EGCs</u></b>	<b><u>Other Publicly Listed Companies</u></b>
Number of Companies	1,970	1,168	802	4,317
Companies with Management ICFR Report	993 (50%)	680 (58%)	313 (39%)	4,157 (96%)
Material Weakness in ICFR Noted by Management	525 (53%)	480 (71%)	45 (14%)	284 (7%)

### **Auditors**

Approximately 39 percent of EGCs were audited by firms that were annually inspected in 2015 and 61 percent of EGCs were audited by firms that are subject to inspection at least every three years by the PCAOB, containing U.S. firms (48 percent), firms that are non-U.S. affiliates of annually inspected firms in 2015 (9 percent), other non-U.S. firms (4 percent).