PCAOB
Public Company Accounting Oversight Board

1666 K Street, NW
Washington, D.C. 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org

SUPPLEMENTAL REQUEST FOR COMMENT:

PROPOSED AMENDMENTS RELATING TO THE SUPERVISION OF AUDITS INVOLVING OTHER AUDITORS

AND PROPOSED AUDITING STANDARD—

DIVIDING RESPONSIBILITY FOR THE AUDIT WITH ANOTHER ACCOUNTING FIRM

PCAOB Release No. 2017-005
September 26, 2017

PCAOB Rulemaking
Docket Matter No. 042

Summary: The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is issuing a supplemental request for comment on its April 12, 2016, proposed amendments and proposed standard regarding audits that involve accounting firms and individual accountants outside the accounting firm that issues the audit report. This supplemental request for comment seeks commenters' views on certain revisions to the proposed amendments and proposed standard that the Board is considering for adoption, and on other matters discussed in this release. The Board is also reopening the comment period for the proposed amendments and proposed standard, for additional comments on any other aspects of the proposal.

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 or through the Board's website at 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 November 15, 2017.

Board Contacts: Keith Wilson, Deputy Chief Auditor (202/207-9134, wilsonk@pcaobus.org); Dima Andriyenko, Associate Chief Auditor (202/207-9130, andriyenkod@pcaobus.org); Stephanie Hunter, Assistant Chief Auditor (202/591-4408, hunters@pcaobus.org); Hunter Jones, Chief Counsel (202/591-4412, jonesh@pcaobus.org), Office of the Chief Auditor; John Powers, Senior Financial Economist, Office of Economic and Risk Analysis (202/591-4273, powersj@pcaobus.org).

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I. Overview

On April 12, 2016, the Board issued proposed amendments to PCAOB standards and a proposed standard ("2016 Proposal"[1]) to strengthen requirements that apply to audits involving accounting firms and individual accountants outside the accounting firm that issues the audit report ("other auditors").[2] The proposed new standard would apply when the firm issuing the audit report ("lead auditor") divides responsibility for an audit with another accounting firm ("referred-to auditor") and refers to the audit report of the other firm in the lead auditor's own audit report. The 2016 Proposal, described in greater detail in Section II.B below, is intended to increase the involvement by the lead auditor in 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.

The Board received comments on the 2016 Proposal through comment letters as well as through discussions of the PCAOB's Standing Advisory Group ("SAG") that occurred in 2016 and 2017. Commenters generally supported the Board's objective of improving the quality of audits involving other auditors. Some commenters, including those who supported the overall direction of the proposal, expressed concerns or requested clarification about certain proposed requirements in areas such as determining the lead auditor's sufficiency of participation, supervising the work of other auditors, or dividing responsibility with another auditor in certain situations.

The Board, in light of the views and information contained in comments on the 2016 Proposal, is considering for adoption certain revisions to the amendments it proposed in 2016. This supplemental request for comment (i) discusses significant comments received on the 2016 Proposal, (ii) presents the revisions to the proposed amendments that the Board is considering for adoption (described as "considering revising" or "considering revisions" throughout this release), and (iii) requests comment on those revisions and related matters. The Board also is reopening the comment

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[1] *Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard—Dividing Responsibility for the Audit with Another Accounting Firm*, PCAOB Release No. 2016-002 (Apr. 12, 2016). Readers may find it useful to refer to the 2016 Proposal when reading this supplemental request for comment.

[2] This release uses general meanings of "lead auditor" and "other auditors" for ease of explanation. The text of proposed amendments to standards in Appendices 1 through 3 includes more specific definitions of the terms for purposes of applying certain PCAOB standards. 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, *Audit Planning* (defining "other auditor" and "referred-to auditor"). *See also* the 2016 Proposal at 4, note 1.

period for the 2016 Proposal for any additional comments from the public on any other aspects of the 2016 Proposal.

II. Background

A. Audits Involving Other Auditors

As discussed in the 2016 Proposal, audits of many international companies include work that is performed by accountants other than the firm issuing the audit report. The work of other auditors may account for a significant share of the audit and may involve areas of high risk of material misstatement. It is important for investor protection that the lead auditor assure the audit involving other auditors 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.[3]

Working with other auditors can pose challenges in the coordination and communication between the lead auditor and other auditors. Without adequate supervision by the lead auditor, deficiencies in other auditors' work can result in deficient audits.[4] Over the past several years, PCAOB oversight activities have identified significant audit deficiencies relating to the work performed by other auditors and the lead auditor's role in the audit.[5]

To address challenges posed by the other auditors' involvement, some accounting firms in recent years changed how they supervise other auditors. These changes appear to have contributed to improvements in the quality of work performed by other auditors. Other firms, however, have not significantly changed their approach to the supervision of other auditors. Observations from PCAOB oversight activities indicate that investor protection could be further improved by, among other things, the lead auditor's increased involvement in and evaluation of the work of other auditors.[6]

B. The 2016 Proposal

The 2016 Proposal is designed to strengthen the existing requirements and impose a more uniform approach to the lead auditor's supervision of other auditors. The proposed amendments and proposed standard are intended to increase the lead

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[3] *See* Section II of the 2016 Proposal.

[4] The 2016 Proposal also addresses matters relating to the coordination of activities between the lead auditor and referred-to auditor in audits when the lead auditor divides responsibility.

[5] *See* Sections II.B.2(i) and II.B.2(ii) of the 2016 Proposal.

[6] *See* Sections II.B.2(iv) and II.C of the 2016 Proposal.

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.

Currently, two PCAOB standards – AS 1201, *Supervision of the Audit Engagement,* and AS 1205, *Part of the Audit Performed by Other Independent Auditors* – take different approaches to how the lead auditor supervises, or uses, the work of other auditors. AS 1201 sets forth the primary requirements for the supervision of the audit engagement, including supervising the work of engagement team members. In contrast, AS 1205 allows the lead auditor, under certain conditions, to use the results of the other auditor's work after performing specified, but limited, procedures.

In brief, the proposed amendments and proposed standard in the 2016 Proposal would:

- Supersede AS 1205, *Part of the Audit Performed by Other Independent Auditors*. Superseding AS 1205 would eliminate the lead auditor's ability to use the "work and reports" of other auditors under that standard. Instead, the lead auditor would be required either to (i) supervise the other auditors' work under AS 1201 when the lead auditor assumes responsibility for that work, or (ii) comply with proposed AS 1206 when the lead auditor divides responsibility for the audit with another accounting firm.

- Amend AS 1201, *Supervision of the Audit Engagement*. The 2016 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 require certain procedures to be performed by the lead auditor with respect to the supervision of the other auditors' work. Under the 2016 Proposal, the lead auditor would remain responsible for the supervision of the entire audit.

- Amend AS 2101, *Audit Planning*. The 2016 Proposal includes a number of amendments to AS 2101. In general, these amendments incorporate and update certain requirements from AS 1205 (which is proposed to be superseded), and amend certain existing requirements to specify that they be performed by the lead auditor. For example, the 2016 Proposal would enhance the requirement governing the lead auditor's assessment of whether it performs sufficient work on the audit to warrant serving as lead auditor.

- Amend AS 1215, *Audit Documentation*. The 2016 Proposal would amend the requirement in AS 1215 regarding the documentation to be obtained, reviewed, and retained by the office of the firm issuing the auditor's report when other offices of the firm or other auditors are involved in the audit.

- Amend AS 1220, *Engagement Quality Review*. The 2016 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.

- Provide a new standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*. The new standard would retain, with modifications, many of the current requirements that apply when the lead auditor divides responsibility with another accounting firm under AS 1205 (which would be superseded). The new standard also would establish certain new requirements.

- Include definitions of "engagement team," "lead auditor," "other auditor," and "referred-to auditor," to operationalize the proposed requirements.

C. Comments on the 2016 Proposal

The PCAOB received 23 comment letters on the 2016 Proposal. In addition, the Board devoted two sessions of its SAG meetings in May and December of 2016 to the discussion of matters relating to the proposal. Matters relating to the proposal were also discussed in the May 2017 SAG meeting.

Commenters generally supported the Board’s objective of improving the quality of audits involving other auditors. In particular, a number of commenters supported the Board's consideration of a scalable, risk-based approach to the supervision of other auditors' work. Most commenters also agreed with retaining an option (currently in PCAOB standards) for the lead auditor to divide the responsibility for the audit with another accounting firm.

A number of commenters, however, identified matters that, in their view, would require modification or clarification, principally related to the following subjects in the 2016 Proposal:

- Planning, including the sufficiency of lead auditor's participation and other auditors' qualifications;

- Supervision, including the communication between auditors and supervision of multiple tiers of other auditors;

- Division of responsibility, including situations that involve differing financial reporting frameworks;

- Documentation, including the documentation of the lead auditor's review;
- Engagement quality review; and
- Definitions.

After analyzing comments on the 2016 Proposal, the Board is considering for adoption certain revisions to the amendments to PCAOB auditing standards it proposed in 2016.

D. Purpose of the Supplemental Request for Comment

This supplemental request for comment (i) discusses significant comments received on the 2016 Proposal, (ii) presents the revisions to the proposed amendments that the Board is considering for adoption, and (iii) requests comment on those revisions and related matters.

Appendix 1 contains the text of revisions to the 2016 Proposal the Board is considering for adoption. Appendix 2 contains the same text of revisions (other than the proposed new standard, AS 1206), shown as cumulative proposed amendments to existing PCAOB standards. Appendix 2 thus shows the amendments proposed in 2016, modified for the revisions to those amendments that the Board is considering for adoption. Appendix 3 contains the proposed new standard, AS 1206, including revisions that the Board is considering for adoption.

This release contains questions on proposed rule text and other matters on which the Board is seeking comment. Readers are encouraged to answer the questions and also to comment on any aspect of the release or amendments not covered by specific questions. In addition, the Board continues to consider for adoption proposed amendments in the 2016 Proposal that are not discussed in this release. The Board is therefore reopening the comment period for the 2016 Proposal for any additional comments on any aspects of the 2016 Proposal. For all comments submitted, commenters are encouraged to provide reasoning to support their views and any data relevant to their comments.[7]

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[7] Studies, memoranda, or other substantive items may be added by the Board or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Board's website. To ensure direct electronic receipt of such notifications via e-mail, subscribe to PCAOB updates at http://pcaobus.org/About/Pages/PCAOBUpdates.aspx.

III. Comments on and Revisions to the 2016 Proposal

A. Audit Planning

1. Determination to Serve as Lead Auditor (Sufficiency of Participation)

See proposed paragraph .B2 of AS 2101 on p. A1-2 in Appendix 1

The 2016 Proposal would require the engagement partner to determine whether his or her firm's participation in the audit is sufficient for the firm to serve as lead auditor. As proposed, the engagement partner would need to take into account the risks of material misstatement associated with the portions of the financial statements audited by the firm, relative to those portions audited by other auditors and referred-to auditors. The 2016 Proposal would extend this requirement to all audits involving other accounting firms, not merely those covered by existing AS 1205.[8]

Some commenters sought clarification regarding the 2016 Proposal's sufficiency of participation requirement. They asked whether the proposal would require the engagement partner to compare the work of his or her firm to each other auditor singly or to all other auditors in the aggregate, when evaluating whether his or her firm's participation in the audit is sufficient for the firm to serve as lead auditor.

Other commenters expressed concerns that the criterion in the 2016 Proposal regarding the risks of material misstatement was primarily quantitative and too narrow, and that in certain situations the proposed requirement for sufficiency determination may pose practical challenges. Some of those commenters said that sometimes the auditor best positioned to serve as lead auditor might not meet the proposed criterion, for example, if the lead auditor audited only the corporate headquarters and other auditors audited the company's operating units. Commenters also suggested modifications to the proposed requirements for determining sufficiency of participation, including additional criteria to be considered, for example: company characteristics such as legal domicile, location of the company's books and records or key decision-makers, legal jurisdiction of the company headquarters; and audit firm factors, such as where the firm is licensed, knowledge of the other participating audit firms, and existence of relevant network affiliations. Additionally, a few commenters suggested allowing the lead auditor's close supervision of another auditor to count toward the lead auditor's participation for purposes of the assessment.

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8 The existing requirement regarding the sufficiency of participation in paragraph .02 of AS 1205 (which would be superseded by this release) applies only to audits covered by AS 1205.

After considering commenters' views, the Board has preliminarily concluded that the engagement partner of the prospective lead auditor should, when assessing his or her firm's sufficiency of participation in the audit, expressly take into account the importance to the company's financial statements of the locations where the firm performs its work. Therefore, the Board is considering revising the provisions for assessing a prospective lead auditor's sufficiency of participation to expressly require consideration of the importance of the locations or business units audited by the lead auditor. Specifically, the lead auditor would be required to consider both (i) the risks of material misstatement associated with the portion of the financial statements audited by the lead auditor (which was proposed),[9] and (ii) the importance of the locations or business units for which the lead auditor performs procedures, in relation to the financial statements of the company as a whole, taking into account quantitative and qualitative factors (an additional consideration). Including importance as an additional consideration would more expressly address circumstances where, for example, the lead auditor audits the locations or business units where the primary financial reporting decisions are made and consolidated financial statements are prepared, even though they might not comprise a significant portion of the company's operations.[10] Notably, the importance consideration is similar to an existing factor in AS 1205.[11] Under this requirement, the engagement partner would compare the lead auditor's portion of the audit to the portions audited by each other auditor or referred-to auditor singly, not in the aggregate.[12]

Additionally, in light of commenters' views that the number of divided responsibility engagements may increase,[13] the Board is considering adding another

[9] The 2016 Proposal includes a specific reference to materiality that, as proposed to be revised, would be encompassed by the qualitative and quantitative factors to be considered under the criterion on importance.

[10] The 2016 Proposal presented examples of the application of the sufficiency of participation criteria. This revision to the requirement would not alter the conclusion in those examples; it would merely give more prominence to the consideration of the importance of locations and business units in the analysis of those examples.

[11] One of the criteria provided in AS 1205.02 is "the importance of the components [the auditor] audited in relation to the enterprise as a whole."

[12] The process under the expanded requirement of taking into account specified considerations and making comparisons to other firms singly is similar to the process under AS 1205, although the specified considerations would differ.

[13] Based on PCAOB staff analysis of SEC filings as of August 3, 2017, Form 10-K filings showed approximately 33 and 43 audits in which the lead auditor divided responsibility with another auditor in fiscal years 2016 and 2015, respectively;

sufficiency threshold to be met by the lead auditor in prospective divided responsibility engagements, along with the criteria discussed above. Specifically, the Board is considering including a sufficiency criterion as follows:[14]

> [T]he participation of the engagement partner's firm to serve as lead auditor ordinarily is not sufficient if the referred-to auditors, in aggregate, audit more than 50 percent of the company's assets or revenues.

This additional threshold is intended to reduce the likelihood that the lead auditor, who issues the audit report on a company's consolidated financial statements, would divide responsibility with an audit firm (or firms) that audits a majority of the company's assets or revenue.

This additional threshold for divided responsibility engagements is analogous to a quantitative threshold that appears in staff guidance set forth in the Financial Reporting Manual of the Securities and Exchange Commission ("SEC") Division of Corporation Finance.[15] Including this threshold would reflect practice that has long been adopted by the profession.

This threshold is not a bright-line test, but instead would create a presumption that the lead auditor will not divide responsibility with an audit firm (or firms) that audits a majority of the company's assets or revenue.[16] In the exceptional situations where a firm could overcome the presumption and serve as lead auditor, the firm would need to document why its participation in the audit was sufficient to do so, including how it satisfied the criteria based on the importance of the locations or business units it audited and risk of material misstatement associated with the portion of the company's financial statements that it audited. Examples of situations where this might arise

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Form 20-F filings showed approximately 15 and 16 such audits in fiscal years 2016 and 2015, respectively.

[14] Section III.C of this release discusses further conditions to be met in order to divide responsibility with another accounting firm.

[15] The Division of Corporation Finance's Financial Reporting Manual provides that a lead auditor is generally expected to have audited or assumed responsibility for at least 50 percent of the assets and revenues of the consolidated entity. *See* SEC, Division of Corporation Finance, Financial Reporting Manual, Section 4140.1.

[16] Notably, while the comparison based on the importance of the locations or business units and risk of material misstatement associated with the portion of the financial statements is made singly, the additional threshold based on assets and revenue is made for all referred-to auditors in the aggregate.

include, but are not limited to, significant late-year acquisitions or other unanticipated events or conditions that increase the portion of assets or revenue audited by referred-to auditors beyond the 50 percent threshold.

Finally, the Board considered, but has preliminarily rejected, including audit firm factors as criteria in the sufficiency determination (e.g., where the firm is licensed, the firm's knowledge of the other participating audit firms, and the existence of relevant network affiliations) because the sufficiency determination should be based on the work the auditor performed on the audit, rather than on the auditor's attributes. Also, the Board does not currently intend to change the requirement so that close supervision of other auditors' work by the lead auditor would count toward the lead auditor's participation, as suggested by some commenters. Creating separate categories of supervision, and treating the categories differently, would be inconsistent with an existing principle in AS 1201[17] that the Board believes is appropriate to preserve – namely, that the extent of supervision should be based on specified factors such as the risk of material misstatement.

Questions:

1. Is the revised requirement for determining the sufficiency of participation to serve as lead auditor, based on risk and importance of the locations, appropriate and clear?

2. Is the additional sufficiency threshold for divided responsibility engagements clear? Should this be a bright-line requirement, or does this threshold need to allow for exceptional situations? Are there any other implications of this threshold that the Board should consider, such as investor protection implications or auditing challenges related to the revised requirement?

2. Other Auditors' Compliance with Independence and Ethics Requirements

See proposed paragraph .B4 of AS 2101 on p. A1-3 in Appendix 1

The 2016 Proposal would require, in audits that involve other auditors,[18] that the lead auditor determine other auditors' compliance with the SEC's independence and the

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17 *See* AS 1201.06 in Appendix 2 of this release.

18 *See* proposed AS 1206 in Appendix 3 of this release for the requirements with respect to obtaining representation regarding the referred-to auditor's compliance with SEC independence requirements and PCAOB independence and ethics requirements.

PCAOB's independence and ethics requirements by doing the following: (i) understanding each other auditor's knowledge of independence and ethics requirements and experience in applying the requirements, and (ii) obtaining a written representation from each other auditor that it is in compliance with independence and ethics requirements. The 2016 Proposal would build on existing requirements in PCAOB standards to determine compliance with independence and ethics requirements.[19]

Commenters generally agreed that understanding the qualifications (including independence and ethics) of the other auditor is important. Some commenters, however, questioned the practicability of applying the required procedures in the proposal to individual engagement team members. Some commenters asked whether the lead auditor would satisfy the proposed requirement by obtaining from a firm that serves as other auditor a representation that also encompasses all applicable persons at the firm. Some commenters suggested that the lead auditor should be allowed to rely on its network's quality control system when the other auditor and the lead auditor are in a common network.

After considering the comments, the Board is considering revisions to the proposed requirement. Specifically, the lead auditor would be required to understand the other auditor's[20] "process for determining compliance" with the independence and ethics requirements and experience in applying the requirements, rather than understand the other auditor's knowledge of the requirements. By focusing the lead auditor on the other auditor firm's process for determining compliance and its experience with the requirements, the lead auditor would be in a better position to identify matters that may warrant further attention, as compared to merely understanding the other auditor's knowledge of the requirements. For example, the lead auditor might become aware of gaps in the other auditor's process for identifying prohibited financial relationships of covered persons, and the lead auditor might ask the other auditor to ascertain whether independence violations might have occurred in that area.

Additionally, the Board is considering adding a requirement for the lead auditor to obtain a written description from each other auditor regarding all relationships between

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19 *See*, *e.g.*, AS 2101.06b in Appendix 2 of this release.

20 The proposed definition of "other auditor" includes both a firm and individuals from that firm. As a practical matter, this requirement would typically be applied at the firm level because the other auditor firm would typically have both the processes for determining compliance with PCAOB independence and ethics requirements and SEC independence requirements and some level of experience in applying those requirements. This requirement would be applied at the individual level for participating persons who are not part of a firm.

the other auditor and the audit client or persons in financial reporting oversight roles at the audit client that may reasonably be thought to bear on independence.[21] This additional requirement would help reinforce and support the need for the lead auditor to receive information that is important to the lead auditor's determination of compliance with SEC and PCAOB independence requirements, and facilitate auditor communications under PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*.[22]

The Board also is considering revising the description of the required representation from the other auditor to the lead auditor. As revised, the lead auditor would be required to obtain a representation from the other auditor "that it is, or is not, in compliance" with independence and ethics requirements, and if not in compliance, to obtain a description of the nature of any non-compliance. This revision would clarify the intent of the proposed representation requirement—to obtain confirmation that the other auditor is in compliance with the independence and ethics requirements or, in the alternative, an explanation of the nature of any non-compliance. The other auditor firm could make a written representation that encompasses all covered persons of that firm. Similarly, the other auditor firm's written description to the lead auditor regarding any relationships between the firm and the audit client or persons in financial reporting oversight roles at the audit client that may reasonably be thought to bear on independence could include the firm's covered persons. In both instances, obtaining from a firm a written representation or description that also encompasses relevant individuals at the firm, would satisfy the requirement to obtain a written representation or description "from each other auditor," for those persons at that firm.

Because of the wide variety of circumstances in which other auditors are used, the Board does not currently intend to prescribe how the lead auditor should gain an understanding of the other auditor's process for determining compliance with the independence and ethics requirements and experience in applying them. Rather, the lead auditor should determine the necessary procedures to obtain a sufficient understanding under the circumstances. For example, the lead auditor may obtain a written description of the other auditor's process and results of the process, or may obtain this understanding through inquiry, and perform follow-up procedures as necessary to address gaps in the process or indications of potential noncompliance.

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[21] PCAOB Rule 3501, *Definitions of Terms Employed in Section 3, Part 5 of the Rules*, defines the terms "audit client" and "financial reporting oversight role."

[22] Rule 3526 requires auditors to make certain communications to the audit committee of the audit client before accepting an initial engagement, and annually thereafter, including a description, in writing, of "all relationships between the registered public accounting firm or any affiliates of the firm and the audit client or persons in financial reporting oversight roles at the audit client that, as of the date of the communication, may reasonably be thought to bear on independence."

Factors that may affect the necessary level of effort in obtaining the understanding of the other auditor's process and experience include the lead auditor's existing knowledge of the other auditor's process; the lead auditor's experience with the other auditor's past compliance with the ethics and independence requirements; changes in the other auditor's processes or circumstances that may affect the risk of non-compliance; and other information available to the auditor about the other auditor's practices or compliance with independence and ethics requirements.

Information obtained by the lead auditor about the other auditor could either support or contradict the other auditor's representation regarding compliance with independence and ethics requirements or the written description of relationships between the other auditor and the audit client or persons in financial reporting oversight roles at the audit client that may reasonably be thought to bear on independence. The following are possible examples of the types of information that might contradict or raise doubt about an assertion of compliance: lack of a process for identifying non-audit services provided to audit clients; previously undisclosed business relationships with audit clients; or violations identified by the other auditor or others (e.g., regulators) of the independence and ethics requirements. Relevant information about the other auditor may come either directly from the other auditor or from other sources, such as regulatory reports or news articles.

The Board has preliminarily decided not to allow "reliance" on a network in determining the other auditor's compliance with independence and ethics requirements, as some commenters suggested (i.e., the Board would retain the relevant 2016 amendments as proposed). Affiliation with the same network does not automatically provide the lead auditor with an understanding of the other affiliates' processes and experience. Although the lead auditor might be able to access more readily information about network affiliates than non-affiliated firms, the lead auditor remains responsible for obtaining the required understanding of the other auditors' processes for and experience with complying with independence and ethics requirements.[23]

Question:

3. Are the revised requirements relating to the other auditors' compliance with the independence and ethics requirements appropriate? Are there any practical challenges associated with the revised amendments? If so, what are they, and how could the proposed requirements be revised to address the challenges?

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[23] See the discussion above regarding factors that may affect the necessary level of effort in obtaining the understanding of the other auditor's process and experience.

3. Other Auditors' Knowledge, Skill, and Ability

See proposed paragraph .B6 of AS 2101 on p. A1-4 in Appendix 1

The 2016 Proposal would require the lead auditor to understand the knowledge, skill, and ability of other auditors who assist the lead auditor in planning or supervising the audit.

Commenters generally supported this new requirement. Some commenters recommended requiring the lead auditor to understand the knowledge, skill, and ability of all of the engagement team members at the other auditor, not only those who assist with planning and supervision. Some commenters also suggested requiring the lead auditor to consider indirect information about the other auditor, such as past experience with the other auditor and public information about enforcement actions and inspection reports. Some commenters suggested that the lead auditor should be allowed to rely on its network's quality control system when the other auditor and the lead auditor are in a common network.

The Board agrees that non-supervisory engagement team members may be involved in important audit areas requiring significant expertise and judgment. Thus, the Board is considering a new provision, requiring the lead auditor to inquire about the other auditor's policies and procedures[24] related to the training of all personnel who work on audits performed under PCAOB standards and the assignment of personnel to PCAOB audits.[25]

By understanding the other auditor's policies and procedures for training and assigning its personnel, the lead auditor would be in a better position to identify matters that may warrant further attention. For example, if non-supervisory team members are not required to be trained on PCAOB standards, the lead auditor may decide to obtain additional information about the knowledge, skills, and ability of personnel performing important audit tasks in determining the necessary extent of supervision of their work. This new requirement seeks to promote the supplying of important information to the lead auditor without imposing unduly detailed requirements for all engagement team members from the other auditor.

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[24] The proposed definition of "other auditor" includes both a firm and individuals from that firm. As a practical matter, this requirement would typically be applied at the firm level because the other auditor firm would have the relevant policies and procedures. The requirement would be applied at the individual level for participating persons who are not part of a firm.

[25] *See* proposed AS 2101.B6a in Appendix 1 and Appendix 2 of this release.

The Board does not currently intend to prescribe how the lead auditor should gain an understanding of the other auditors' knowledge, skill, and ability. The nature and extent of the lead auditor's procedures would depend to a large extent on the types of information available to the lead auditor about the other auditors. The Board expects, however, that gaining an understanding of the other auditors' knowledge, skill, and ability would necessarily involve obtaining information about the individuals who assist the lead auditor in planning or supervising the audit. For example, merely obtaining a statement from an affiliated firm (other auditor) that the firm complies with network-wide qualification requirements for personnel assigned to PCAOB audits would not provide sufficient information if the statement lacks specific information about the supervisory personnel on the engagement. Additional details about the knowledge, skill, and ability of those personnel would be needed to determine whether those individuals are qualified to perform the tasks assigned by the lead auditor. Possible sources of information that are relevant to the lead auditor's understanding of the knowledge, skill, and ability of relevant personnel include the lead auditor's own experience working with them, the other auditor's policies regarding the nature, scope, and timeliness of relevant training for them, information about internal inspection results regarding them, and publicly disclosed disciplinary action by regulators against them.[26]

Question:

4. Are the proposed amendments relating to the knowledge, skill, and ability of the other auditor, revised by this release, appropriate? Are there any practical challenges associated with the revised amendments? If so, what are they, and how could the proposed requirements be modified to address the challenges?

B. Supervision of Other Auditors

1. Risk-based Supervisory Approach

See proposed AS 1201 in Appendix 2

As discussed above, the 2016 Proposal would supersede AS 1205 and eliminate the ability of lead auditors to use the "work and reports" of other auditors under that standard. This would, in effect, require lead auditors to supervise other auditors under AS 1201 when the lead auditor assumes responsibility for the other auditors' work.[27] The proposal also would amend AS 1201 to provide additional direction to the lead

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[26] *See* the 2016 Proposal at A4-26.

[27] Alternatively, proposed AS 1206 would apply when the firm issuing the audit report divides responsibility for an audit with another accounting firm and refers to the audit report of the other firm in the lead auditor's own audit report.

auditor on how to apply the principles-based provisions of AS 1201 to the supervision of other auditors.[28]

In general, commenters supported the Board's consideration of a scalable, risk-based approach to the supervision of the other auditor's work that is grounded in existing PCAOB standards on supervision. For example, a number of commenters indicated that the level of the lead auditor's supervision should vary with the risks of material misstatement and the competency of the other auditors. Some of those commenters, however, questioned whether certain proposed requirements are designed to provide for variability in the level of supervision based on risk and the other auditors' competency.

The proposed requirements for the lead auditor's supervision of the work of other auditors are designed to be scalable based on risk and other factors. Under the 2016 Proposal, the engagement partner and others who assist the engagement partner in supervising the audit should determine the necessary extent of supervision, based on the risks of material misstatement to the company's financial statements and the knowledge, skill, and ability of the other auditor, among other things.[29] The application of this approach to certain specific proposed requirements is discussed in the sections below.

2. *Instructing Other Auditors*

See proposed paragraph .B2 of AS 1201 on p. A1-6 in Appendix 1

The 2016 Proposal would require the lead auditor to, among other things, communicate to the other auditor the scope of work to be performed and the tolerable misstatements and risks of material misstatement related to the work.

Commenters did not object to the general direction of the proposed amendments but suggested certain changes or clarifications. Some commenters suggested that the lead auditor's communication of risks of material misstatement be limited to risks that are relevant to the other auditor's work or to significant risks. Also, some commenters raised questions as to whether the lead auditor is the auditor best suited in all circumstances to assess risks of material misstatement at locations or business units audited by other auditors.

The Board does not currently intend to change the rule text for this proposed requirement because that requirement already provides that the lead auditor should communicate to the other auditors those risks of material misstatement that are relevant

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[28] *See* Section IV of Appendix 4 of the 2016 Proposal.

[29] *See* AS 1201.06 and proposed AS 1201.B1 in Appendix 2 of this release.

to the other auditors' work.[30] Confining the communication requirement to significant risks would, in effect, ignore risks that still pose a reasonable possibility of material misstatement to the financial statements and, in turn, could lead to inadequate testing of significant accounts and disclosures. Any risks not identified by the lead auditor in its initial communication to the other auditor would be covered by an existing provision in AS 1201 to instruct the other auditors to bring any significant auditing issues, including any additional risks of material misstatement identified by the other auditor, to the attention of the engagement partner or other team members who perform supervisory activities.[31] Furthermore, under the 2016 Proposal, 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.[32]

3. Other Auditor Accountability and Duty to Provide a Written Report

See paragraph .02 of AS 1015 on p. A1-8 and proposed paragraph .B2 of AS 1201 on p. A1-6 in Appendix 1

The proposed amendments would not have retained the statement currently in AS 1205.03 (which would be superseded) that "the other auditor remains responsible for the performance of his own work and for his own report." The 2016 Proposal includes a new requirement in the standard on supervision according to which the lead auditor should obtain from the other auditor a written report describing the other auditor's procedures, findings, conclusions, and if applicable, opinion. The proposed requirement was intended to require the other auditor to make a written statement, and to inform the lead auditor, about the work for which the other auditor was responsible and the results of that work.

Some commenters expressed concern that the 2016 Proposal did not include the statement in AS 1205.03 about the other auditor's responsibility. Omitting this provision, in the commenters' view, may be interpreted as a reduction in the responsibility and accountability of the other auditors, with potential adverse effects on audit quality. Some commenters recommended retaining the existing provision or including an analogous requirement to address the other auditors' responsibility.

Additionally, regarding the proposed requirement for a "written report" from the other auditor to the lead auditor, some commenters asked for guidance on the content and form of such reports.

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30 *See* proposed AS 1201.B2a(2) in Appendix 2 of this release.

31 *See* AS 1201.05b in Appendix 2 of this release.

32 *See* proposed AS 2101.14 in Appendix 2 of this release.

In light of comments received, the Board is considering a revision that would amend AS 1015, *Due Professional Care in the Performance of Work,* to include a statement that other auditors are responsible for performing their work with due professional care.[33] This amendment would expressly remind other auditors of their current responsibility for their work under PCAOB rules and standards.[34]

Regarding the comments about the written report, the Board wishes to point out that the other auditor's report is a non-public communication, to be tailored to meet the lead auditor's needs under its supervisory responsibilities, not a standardized report for general public use. Thus, the Board does not currently intend to prescribe the format of the other auditor's report. The required content of the report would remain the same as originally proposed – a description of the other auditor's procedures, findings, conclusions, and, if applicable, opinion, in sufficient detail for the necessary level of supervision.[35] To distinguish more clearly non-public communications between other auditors and the lead auditor (internal communication between two parties) from audit reports issued for general public use, the Board is considering a revision that would replace "written report" with "summary memorandum" in the proposed amendments to AS 1201.

As revised, this requirement to obtain a summary memorandum from the other auditor would be generally consistent with existing auditing practice. Observations from the Board's oversight activities indicate that many audit 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. The form and content of those communications can vary, for example, depending on the nature of the work performed or whether the communication occurs between affiliated firms in the same network.

Question:

5. Are the proposed new addition to AS 1015 and revision to AS 1201 relating to the other auditors' responsibility appropriate and clear? Is it clear that AS 1015 already applies to referred-to auditors that perform audits under PCAOB standards?

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33 *See* proposed AS 1015.02 in Appendix 1 and Appendix 2 of this release.

34 This amendment would not, of course, establish the sole responsibilities of other auditors. Like all auditors that participate in an audit performed under PCAOB standards, other auditors must comply with applicable PCAOB standards. *See, e.g.*, PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*.

35 Section III.B.4 of this release discusses the necessary level of review.

4. Reviewing the Other Auditor's Work

See proposed paragraph .B2 of AS 1201 on p. A1-6 in Appendix 1

Existing PCAOB standards establish requirements for the auditor's review of the work of the engagement team, and for the audit documentation that the office issuing the auditor's report is required to obtain, review, and retain.[36] The 2016 Proposal would provide additional direction to the lead auditor regarding the review of the other auditor's work. The 2016 proposed amendments would cover:

- Obtaining and reviewing the other auditor's description of the nature, timing, and extent of its audit procedures;[37]
- Directing the other auditor to provide for review specified documentation of its work (which includes, but is not limited to, the documentation currently required by PCAOB standards);[38] and
- Obtaining from the other auditor a written report.[39] (As discussed above, the Board is considering revising the amendments to replace the term "written report" with "summary memorandum.")

Some commenters recommended clarifying whether the lead auditor would be allowed to adjust the extent of its review based on risk and the knowledge, skill, and ability of the other auditors' personnel who have already reviewed the work. Some commenters asked whether the lead auditor would be required to review all of the other auditors' audit documentation, including all of its planning documentation. In addition, some commenters suggested allowing the lead auditor to perform alternative procedures instead of reviewing documentation (e.g., holding discussions with other auditors, or reviewing documents remotely). Alternative approaches may be needed, in the commenters' view, if the other auditors' documentation is in a foreign language, or if the lead auditor's access to the documentation is restricted.

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[36] *See* AS 1215.19. *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. Notably, proposed AS 2101.B6 requires the lead auditor to determine at the beginning of the engagement that the lead auditor is able to gain access to the other auditor's audit documentation. This access is important to enable the lead auditor to comply with the requirements of AS 1215 and to perform the required reviews in proposed AS 1201.B2.

[37] *See* proposed AS 1201.B2b in Appendix 1 of the 2016 Proposal.

[38] *See* proposed AS 1201.B2c in Appendix 1 of the 2016 Proposal.

[39] *See* proposed AS 1201.B2d in Appendix 1 of the 2016 Proposal.

Under the 2016 Proposal, the lead auditor would be required to determine the extent of audit documentation to be obtained and reviewed (e.g., other auditor's planning documentation, as well as the description of procedures performed, findings, conclusions, etc.) based on the factors set forth in the existing standard regarding the necessary extent of supervision.[40] For example, in addition to reviewing the documentation that existing and proposed standards require the lead auditor to review,[41] the lead auditor may need to request from the other auditor and review certain audit documentation in areas involving higher risk or significant judgment.[42] In another example, the lead auditor may need to examine more closely certain work performed and reviewed by the other auditor's personnel who have less expertise in a particular complex subject matter.[43] Similarly, the level of detail in the audit documentation to be obtained and reviewed by the lead auditor would depend on the factors in the existing standard regarding the necessary extent of supervision.[44]

In light of comments received, the Board is considering revisions to proposed AS 1201.B2.[45] Specifically, two new notes would clarify that the necessary level of detail in the other auditor's documentation to be obtained and reviewed by the lead auditor should be determined by the lead auditor depending on the necessary extent of supervision of the other auditor's work.

The Board does not currently intend to change its standards to allow the lead auditor merely to hold discussions with the other auditor instead of reviewing the other auditor's documentation (although this does not preclude the lead auditor from using technology in order to review audit documentation). Proper review of audit documentation is an essential component of effective supervision.[46] However, as

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[40] *See* AS 1201.06 in Appendix 2 of this release.

[41] *See* (i) AS 1215.19, as proposed to be amended (in Appendix 2 of this release), and (ii) revised amendments relating to certain written communications from the other auditor in revised proposed AS 1201.B2d (in Appendix 1 and Appendix 2 of this release), which are described in Sections III.D and III.B.3 of this release.

[42] *See* AS 1201.06c in Appendix 2 of this release.

[43] *See* AS 1201.06d in Appendix 2 of this release. *See also* proposed AS 2101.B6b in Appendix 2 of this release (requiring the lead auditor to gain an understanding of the knowledge, skill, and ability of the other auditors who assist the lead auditor with planning and supervision).

[44] This includes the level of detail of the summary memorandum discussed in Section III.B.3 of this release.

[45] *See* AS 1201.B2 in Appendix 1 and Appendix 2 of this release.

[46] *See, e.g.,* AS 1201.05c in Appendix 2 of this release. If the other auditor's documentation was prepared in a foreign language, the lead auditor would need to

discussed in the prior paragraph, the necessary extent of the review is based on the factors in the existing standard regarding the necessary extent of supervision.

Question:

6. Are the proposed new additions to AS 2101.B2 appropriate and clear? Also, is it clear that the necessary level of detail of the other auditor's audit documentation that the lead auditor obtains and the necessary extent of the lead auditor's review according to requirements in proposed Appendix B of AS 1201 are scalable based on the factors in the existing standard regarding the necessary extent of supervision?

5. Multi-Tiered Audits

See proposed paragraph .B3 of AS 1201 on p. A1-7 in Appendix 1

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 either 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.

For these arrangements, the 2016 Proposal would allow the lead auditor to direct the first other auditor to perform certain supervisory procedures on behalf of the lead auditor. The supervisory procedures that the lead auditor could assign to a first other auditor would have included reviewing the second other auditor's planned procedures and results of their work.[47]

Commenters generally supported addressing multi-tiered audits in the proposed amendments. Some commenters, however, expressed concern about requiring the lead auditor, rather than the first other auditor, to communicate the scope of work, tolerable

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adopt measures to facilitate a sufficient review by the lead auditor under the proposed requirements. For example, relevant audit documentation might be prepared or translated into the lead auditor's language to facilitate the review.

[47] *See* proposed AS 1201.B2b through .B2e in Appendix 1 of the 2016 Proposal, and revisions in Appendix 1 and Appendix 2 of this release.

misstatement, and risks of material misstatement to the second other auditor. Those commenters argued that the first other auditor often is better positioned to make those communications because the first other auditor may understand local operations and controls better than the lead auditor does.

In light of comments received, the Board has preliminarily concluded it would be appropriate to permit a first other auditor to make certain additional communications to a second other auditor in a multi-tiered audit, as long as the lead auditor receives adequate information about the communications. The Board therefore is considering revising the requirements for multi-tiered audits to allow the first other auditor to make the required communications described above, but require the lead auditor nonetheless to obtain, review, and retain a copy of those communications, or equivalent documentation. This revision would allow the most appropriate auditor (lead auditor or first other auditor) to communicate with the second other auditor. It would also enable the lead auditor (who is responsible for the scope of the entire audit) to assess whether the second other auditor is adequately informed, the scope of the second other auditor's work is appropriate, and the first other auditor is properly supervising the second other auditor's work.

Additionally, one commenter argued that certain documentation requirements in PCAOB standards do not take into account an engagement team that has a multi-tiered structure. The commenter discussed paragraph 19 of AS 1215, which requires the office issuing the auditor's report to obtain, and review and retain, prior to the report release date, certain documentation related to the work performed by other auditors, including the engagement completion document and summaries of identified misstatements and control deficiencies. The commenter suggested that it should not be necessary for a lead auditor to obtain and retain in the audit documentation the items noted in AS 1215.19 in relation to a second other auditor if the first other auditor had obtained and reviewed the work that had been performed by the second other auditor.

Consistent with an objective of AS 1215 that the issuing office have access to those working papers on which it placed reliance[48], the Board wishes to emphasize that the lead auditor would remain responsible for obtaining, reviewing, and retaining the documentation required by AS 1215.19, including in multi-tiered audits. In addition, a revision to the proposed amendments would require the lead auditor to obtain, review, and retain a copy of the summary memorandum provided by the second other auditor to the first other auditor. (*See* Section III.B.3 of this release for discussion of the summary memorandum.)

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[48] *See Audit Documentation and Amendment to Interim Auditing Standards*, PCAOB Release No. 2004-006 (June 9, 2004), paragraph A63, at A1-28.

Question:

7. Are the revised 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 revised proposed requirements be revised?

C. Proposed New Standard on Divided Responsibility

The 2016 Proposal includes a proposed new standard, AS 1206, that would apply to situations in which the lead auditor divides responsibility for the audit, and makes reference in the audit report to the audit and report of another firm, the referred-to auditor. The proposed standard would retain, with modifications, certain provisions currently in AS 1205 and would add certain other requirements, such as requiring the lead auditor to obtain a written representation from the referred-to auditor that it is licensed to practice in the relevant jurisdiction.[49]

Commenters generally supported the proposed standard, and some commenters suggested certain revisions. Significant comments received and revisions that the Board is considering are discussed below.

1. Allowing the Division of Responsibility

See proposed AS 1206 in Appendix 3

Most commenters agreed with retaining the divided responsibility approach, which has long been permitted, because they observed no compelling practice issues that would suggest a need for change from this approach. Some commenters, however, expressed concern about the Board retaining the divided responsibility alternative. Those commenters argued that the lead auditor is ultimately responsible for the overall audit opinion and should not refer to other auditors.[50]

After considering the comments, the Board has preliminarily decided to retain the divided responsibility alternative (with certain conditions) to address those situations in which, under the circumstances, it is impracticable for the lead auditor to supervise the work of another audit firm. Without the ability for the auditors to divide responsibility,

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[49] *See* proposed AS 1206.05b in Appendix 3 of this release.

[50] Similar comments were made by certain SAG members at the May and December 2016 SAG meetings and the May 2017 SAG meeting. At the May 2016 and 2017 SAG meetings, the observer from the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA") acknowledged that AICPA standards allow for divided responsibility. (*See* transcript excerpts in Docket 042, available on the PCAOB's website.)

some companies may encounter situations in which no audit firm is in a position to opine on the company's financial statements. For example, if it is impracticable for the lead auditor to supervise the other audit firm (or audit the entire consolidated financial statements), the lead auditor might withdraw from the engagement or disclaim its opinion because the lead auditor is unable to obtain sufficient appropriate evidence. As discussed above, divided responsibility engagements are relatively uncommon.[51]

2. Dealing with Different Financial Reporting Frameworks

See paragraph .06 of proposed AS 1206 on p. A1-12 in Appendix 1

One of the criteria in the proposed new standard for dividing responsibility for the audit is that the company and its business unit have prepared their financial statements using the same financial reporting frameworks (e.g., U.S. GAAP). Commenters expressed concern that this criterion would preclude auditors from dividing responsibility when it would otherwise be appropriate. Those commenters argued that the use of different financial reporting frameworks by business units exists, although relatively rare today,[52] and may become more common with the increasing use of IFRS worldwide.

Other provisions of the standard could address the risks presented when responsibility for the audit is divided between a lead auditor and a firm that audits financial statements prepared using a different financial reporting framework. The Board therefore is considering adopting revisions to the proposed standard to allow division of the responsibility when the company and business unit prepare their financial statements under different financial reporting frameworks if (i) either the lead auditor or the referred-to other auditor audits the conversion adjustments and (ii) the lead auditor's report identifies who has audited the conversion adjustments.[53] These revisions would allow division of responsibility under this practical necessity, while informing investors about which auditor is responsible for auditing the conversion adjustments.

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[51] *See* note 13.

[52] Based on PCAOB staff analysis of SEC filings as of August 3, 2017, Form 10-K and Form 20-F filings in fiscal year 2016 showed approximately five and three audits, respectively, in which the lead auditor divided responsibility with another auditor when the company and subsidiary prepared their financial statements under different financial reporting frameworks. In four of the filings, the lead auditor reported that it audited the conversion adjustments. In the other four filings, the auditor's reports did not indicate which auditor audited the conversion adjustments.

[53] Notably, the lead auditor would continue to be able to divide responsibility with another auditor when the financial statements of the company are prepared under the same financial reporting framework as those of the business unit audited by the referred to auditor, if the criteria a – c of proposed AS 1206.06 are met.

As revised, Appendix B to proposed AS 1206 also would contain examples of the introductory paragraphs in the lead auditor's report when the conversion adjustments are audited by (i) the lead auditor, and (ii) the referred-to auditor.

Question:

8. Is the revision to the proposed standard relating to the division of responsibility when the company and its business unit use different reporting frameworks appropriate and clear?

3. Referred-to Auditor's Qualifications

See paragraph .06b of proposed AS 1206 on p. A3-3 in Appendix 3

Another criterion in the proposed standard for dividing responsibility for the audit is that the lead auditor must determine, based on inquiries of the referred-to auditor and other information obtained during the audit, that the referred-to auditor has knowledge of relevant professional requirements and standards.

One commenter asked whether the lead auditor would be expected to evaluate the knowledge, skill, and ability of the referred-to auditor to the same extent as those of other auditors who are to be supervised. In the commenter's view, an example in the proposing release could go beyond the requirements of proposed AS 1206.[54]

The Board believes that, in light of the comment, further explanation is appropriate. The purpose of understanding the qualifications of other auditors is different from that for referred-to auditors. For other auditors, the lead auditor would gain an understanding of the other auditors' knowledge, skill, and ability and use that understanding in determining the necessary extent of supervision of the other auditors.[55] For referred-to auditors, the lead auditor would make inquiries of the referred-to auditor and use other information obtained during the course of the audit to assess whether the referred-to auditor knows the relevant professional requirements and standards, which the lead auditor considers in deciding whether to divide responsibility for the audit.[56]

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54 In the example, the referred-to auditor discussed his or her prior and current work experience with the lead auditor. *See* Section VII.B.4(iii) in Appendix 4 of the 2016 Proposal.

55 *See* proposed AS 2101.B6b in Appendix 2 of this release.

56 *See* proposed AS 1206.06b in Appendix 3 of this release.

4. Direction on the Decision to Make Reference to the Work and Report of Other Auditors

The proposal would supersede AS 1205 and would not retain certain direction (currently in AS 1205.05-.06) related to the lead auditor's decision to make reference (or not make reference) to the audit and report of another auditor. [57]

Some commenters suggested that the Board retain some or all of the direction in AS 1205.05-.06. In particular, those commenters indicated that firms point to those paragraphs in deciding not to make reference to the audit and report of a network affiliate firm.[58]

The Board does not currently intend to retain the direction suggested by the commenters. While network affiliation might be a practical consideration, the decision to divide responsibility should be determined based on the criteria set forth in the proposed standard and the lead auditor's ability to supervise the other auditor under PCAOB standards, as proposed to be amended.

5. Certain Required Interactions with the Referred-to Auditor

One commenter was concerned that the following proposed amendments would go beyond current practice for the division of responsibility:

- A proposed requirement for the lead auditor to hold discussions with and obtain information from the other auditors <u>or</u> referred-to auditors, as necessary, to identify and assess the risks of material misstatement to the

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57 AS 1205 uses the phrase "make reference" to describe situations in which the lead auditor divides responsibility with the other auditor and makes reference in the lead auditor's report to the audit and report of the other auditor. AS 1205.05-.06 describe situations in which the lead auditor ("principal auditor," as used in the terminology of AS 1205) may decide to make reference to the other auditor and those in which the lead auditor ordinarily would be in a position to issue the audit report without making reference to the other auditor (*i.e.*, the lead auditor would assume responsibility for the other auditor's work).

58 Notably, the standard does not require auditors not to make reference in this situation. It merely states that ordinarily the lead auditor ("principal auditor," as used in the terminology of AS 1205) would be able to decide not to make reference if the other independent auditor "is an associated or correspondent firm…whose work is acceptable to the principal auditor based on his knowledge of the professional standards and competence of that firm."

consolidated financial statements associated with the location or business unit;[59] and

- A proposed amendment to update terminology in paragraph .53 of AS 2401, *Consideration of Fraud in a Financial Statement Audit*, by replacing "other independent auditor" with "other auditors or referred-to auditors," as follows:

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

  * * *

  - If other ~~independent~~ auditors <u>or referred-to auditors</u> are auditing the financial statements of one or more ~~subsidiaries, divisions, or branches,~~<u>of the company's business units,</u> 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~~ <u>business units</u>. * * *

Having considered the comment, the Board is considering retaining the amendments as proposed. Those amendments are consistent with an existing requirement in AS 1205.10 that requires the lead auditor to, among other things, adopt appropriate measures to assure the coordination of its activities with those of the other auditor to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.[60] The requirement to discuss risks with the referred-to auditor is conditioned on, and limited to, the extent to which such discussion is necessary to identify and assess the risks to the consolidated financial statements associated with the location or business unit. And the conforming amendment to AS 2401 does not substantively change the example, but merely updates the terminology to align with the proposal.[61]

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59 *See* proposed AS 2101.14 in Appendix 2 of this release.

60 Notably, AS 1205.10 applies to both scenarios: when the lead auditor assumes responsibility for the other auditor's work and when it divides responsibility for the audit with the other auditor.

61 Under existing PCAOB standards, the term "other auditors" encompasses both categories under AS 1205: those for which the lead auditor assumes responsibility and those with which the lead auditor divides responsibility. The 2016 Proposal uses the term "referred-to auditor" to distinguish it from auditors in the former category.

6. Other Revisions

See paragraphs .05 through .07 of proposed AS 1206 on p. A1-11 in Appendix 1

The Board is considering additional revisions to proposed AS 1206 with respect to the independence and licensing of the referred-to auditor. The 2016 Proposal would require the lead auditor to request a written representation from the referred-to auditor regarding the referred-to auditor's compliance with independence and ethics requirements of the PCAOB and independence requirements of the SEC, and regarding whether the referred-to auditor is licensed to practice under the laws of the applicable jurisdiction.[62] A separate provision of proposed AS 1206 stated that the lead auditor would be permitted to divide responsibility for the audit only if the referred-to auditor's written representation, and the other information obtained by the lead auditor during the audit, indicate that the referred-to auditor is in compliance with the independence and ethics requirements of the PCAOB and independence requirements of the SEC and licensed to practice under the laws of the applicable jurisdiction.[63]

Upon further analysis of these proposed provisions, the Board is considering revising proposed AS 1206.06 by removing the two limitations on the lead auditor's ability to divide responsibility for the audit discussed above. The Board has tentatively concluded that because independence and licensing of a referred-to auditor in AS 1206.06 are already addressed in AS 1206.05, removing the corresponding limitations from AS 1206.06 would reduce the complexity of the proposed standard without diminishing the lead auditor's responsibility to obtain and consider relevant information about the referred-to auditor's independence and licensing.[64] The other limitations in proposed AS 1206.06 on a lead auditor's ability to divide responsibility for the audit would remain, including the responsibility to obtain a representation that the referred-to auditor has performed an audit and issued an auditor's report in accordance with the standards of the PCAOB.

Additionally, the Board is considering revising the language in proposed AS 1206.05a, concerning representations about independence, to more closely conform to existing AS 1205.10.b. As revised, AS 1206.05a would provide that the lead auditor should obtain a written representation from the referred-to auditor that it is independent under the requirements of the PCAOB and of the SEC.[65] This revision would clarify that the Board intends to carry forward the approach in AS 1205.10b.

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[62] *See* proposed AS 1206.05 in Appendix 2 of the 2016 Proposal.

[63] *See* proposed AS 1206.06d in Appendix 2 of the 2016 Proposal.

[64] *See, e.g.,* AS 2101.06b in Appendix 2 of this release.

[65] Under the 2016 Proposal, AS 1206.05a would require the lead auditor to request a written representation that the referred-to auditor is in compliance with the

Finally, the Board is considering replacing the examples in proposed AS 1206.07 of situations in which the auditor is unable to divide responsibility with broader examples, specifically, concerns about the other auditor's qualifications and concerns about whether the referred-to auditor's audit was in accordance with PCAOB standards. The first new example encompasses both competence and, when applicable, registration status. The second example covers situations in which information comes to lead auditor's attention that raises doubt about the referred-to auditor's representation that the audit was in accordance with PCAOB standards.[66]

D. Documentation Amendments

1. Other Auditor's Working Papers Reviewed but Not Retained by Lead Auditor

See AS 1215 on p. A1-9 in Appendix 1

The 2016 Proposal would amend AS 1215 to require the lead auditor to prepare a list that (i) describes the other auditor's documentation which the lead auditor reviewed but did not retain and (ii) states the reviewer and date of review. This new requirement was intended to provide information about the lead auditor's review that currently may not be included in the other auditor's files or may not be accessible outside the country of the other auditor (when an audit involves foreign other auditors).

Some commenters supported the proposed requirement. Other commenters expressed concerns that the proposed requirement would not improve audit quality, but instead would be time-consuming at the end of the audit, and duplicate certain information about the other auditor's documentation.

After evaluating the commenters' arguments in light of other amendments the Board is considering adopting, the Board believes that existing requirements and other proposed requirements may adequately address the need to document the key materials reviewed by the lead auditor. Notably, as discussed above, the Board is considering a revised requirement that the lead auditor obtain, review, and retain a summary memorandum from the other auditor describing the other auditor's procedures, findings, conclusions, and, if applicable, opinion.[67] Even in a multi-tiered audit when the other auditor is supervised by another auditor, the lead auditor would be

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independence and ethics requirements of the PCAOB and independence requirements of the SEC.

[66] This does not require the lead auditor search for contrary evidence or to perform any other procedures to assess the referred-to auditor's work, absent contrary information that raises doubt about the referred-to auditor's audit.

[67] *See* proposed AS 1201.B2d in Appendix 1 and Appendix 2 of this release.

required to obtain, review, and retain a copy of this summary memorandum.[68] The Board is therefore considering a revision that would remove the proposed requirement in AS 1215 that the lead auditor prepare a list of the other auditor's documentation reviewed but not retained by the lead auditor. The lead auditor would remain responsible for obtaining, reviewing, and retaining the information described in AS 1215.19,[69] and would have additional requirements for obtaining and reviewing documentation as discussed in Section III.B.4 of this release.

2. Amendments to AS 1215 Considered but Not Proposed

The 2016 Proposal invites comment on some potential amendments that are not included in the proposal. Specifically, the proposal asks (i) whether the lead auditor's files should list all of the other auditor's documentation, including that not reviewed by the lead auditor; and (ii) whether the office issuing the auditor's report should obtain from the other auditor, review, and retain certain information about related parties, significant unusual transactions, and all control deficiencies.

A number of commenters opposed requiring the lead auditor to list all of the other auditor's documentation. Some commenters added that such a requirement would be impractical and time consuming. Others noted that the cost of compiling a list of (potentially hundreds or thousands of) documents under a tight deadline at the end of the audit would exceed any marginal benefit.

Also, some commenters supported requiring the lead auditor to obtain, review, and retain certain additional information about related parties, significant unusual transactions, and control deficiencies, but other commenters opposed making such communication mandatory. Commenters who opposed the additional documentation generally indicated that, if not further clarified, the potential requirement may result in communicating to the lead auditor information that is inconsequential. One commenter added that the Board should assess the implementation of the auditing standard on related parties before requiring additional documentation in this area.

The Board, having considered the comments submitted, does not currently intend to propose additional requirements in these areas. Requiring the lead auditor to compile a complete list of other auditor's documentation could impose a substantial burden, as the Board acknowledged in the 2016 Proposal, without necessarily

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[68] *See* proposed AS 1201.B3 in Appendix 1 and Appendix 2 of this release.

[69] Additional existing requirements are set forth in AS 1215.18. Also, Section 106(b) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") imposes certain requirements concerning production of the work papers of a foreign public accounting firm on whose opinion or services the auditor relies.

improving audit quality.[70] With regard to additional information about transactions with related parties and significant unusual transactions, the Board notes that its new standard and related amendments in this area recently went into effect, and the Board will continue to monitor the implementation of requirements of its auditing standards to assess the need for further revisions.[71]

E. Engagement Quality Review

AS 1220 requires the engagement quality reviewer to evaluate, among other things, significant judgments made by the engagement team. The 2016 Proposal would amend AS 1220 to require the engagement quality reviewer to evaluate the determination (discussed in Section III.A.1 of this release) that the participation of the engagement partner's firm in the audit is sufficient for the firm to serve as lead auditor, as follows:

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

a. Evaluate the significant judgments that relate to engagement planning, including—

* * *

- 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. * * *

Some commenters supported the proposed requirement. Other commenters opposed the proposed requirement, contending that the sufficiency determination is not always a significant judgment and thus does not always warrant evaluation by the engagement quality reviewer.

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[70] *See* the 2016 Proposal, at A4-42 ("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.").

[71] *See Auditing Standard No. 18—Related Parties, Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2014-002 (June 10, 2014). The new auditing standard and amendments became effective for audits of financial statements for fiscal years beginning on or after December 15, 2014.

The Board is considering retaining the requirement as originally proposed. Although determining the sufficiency of a firm's participation in the audit might not always be difficult or complicated, the decision that the firm can serve as lead auditor is a significant judgment because it affects whether the firm can issue the audit report. Thus, evaluating the sufficiency determination is important for the engagement quality reviewer's conclusion about whether the lead auditor's engagement report is appropriate in the circumstances of a particular audit.[72]

F. Definitions

1. Proposed Definition of "Lead Auditor"

See definition of "lead auditor" in proposed paragraph .A4 of AS 2101 on p. A2-10, proposed paragraph .A4 of AS 1201 on p. A2-19 in Appendix 2, and paragraph .A2 of proposed AS 1206 on p. A3-6 in Appendix 3.

The 2016 Proposal introduces the term "lead auditor" which would apply to both of these scenarios: supervising other auditors under AS 1201 and dividing responsibility for the audit under proposed AS 1206. Under the proposal, the term "lead auditor" would apply to the firm issuing the auditor's report or supervisory personnel from that firm, depending on the context.

Some commenters suggested that the lead auditor definition be expanded to include qualified individuals outside the firm who assist with planning and supervising the audit. The suggested expansion would result in individuals outside the audit firm performing certain supervisory procedures that, under the 2016 Proposal, are reserved for personnel in the firm issuing the audit report.

In response to questions in the 2016 Proposal, a few commenters advocated that individuals performing procedures on an audit who are employees of:

(i) network affiliate firms on secondment arrangements to the lead auditor, or

(ii) shared service centers affiliated with the lead auditor

should be treated as personnel of the lead auditor, not other auditors. These commenters reasoned that these individuals function in the capacity of employees or an equivalent capacity as employees of the lead auditor firm.

The Board is considering retaining the definition of lead auditor as originally proposed. The commenters' concerns about the lead auditor's ability to assign certain planning and supervisory procedures to qualified individuals outside the firm are already

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[72] *See* AS 1220.12.

addressed in this release by the clarification of the proposed extent of the lead auditor's involvement in the supervision of other auditors (discussed in Sections III.B.2 and III.B.4 of this release), and potential revisions to the supervisory procedures for multi-tiered audits (discussed in Section III.B.5 of this release).

The Board agrees that, under the auditing standards amended by its proposal, secondees[73] from other accounting firms and employees of shared service centers[74] working under the lead auditor's guidance and control (as with other individuals who work in the role of firm employees[75]) should be treated as employees of the lead auditor's firm. Importantly, the responsibilities for considering the independence and knowledge, skill, and ability of and for supervising these employees would be the same as for other employees of the lead auditor's firm who worked on the audit.

2. Alignment of Proposed Definitions with Non-PCAOB Rules

In addition to defining the term "lead auditor" (see above), the 2016 Proposal defines the terms "other auditor," "referred-to auditor," and "engagement team." Some commenters noted that the proposed terms are different from the terms used in the International Auditing and Assurance Standards Board's ("IAASB") International Standard on Auditing ("ISA") 600[76] and the AICPA's ASB AU-C Section 600[77], and recommended aligning the terminology of the PCAOB, IAASB, and ASB standards. In

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[73] In this release, the term "secondee" refers to a professional employee of an accounting firm in one country who is physically located in another country, in the offices of another accounting firm, for at least three consecutive months, performing audit procedures with respect to entities in that other country (and not performing more than de minimis audit procedures over the term of the secondment in relation to entities in the country of his or her employer).

[74] In this release, the term "shared service center" refers to an entity affiliated with one or more firms that provides certain audit-related services to the firm(s) (generally standardized audit functions, such as testing the mathematical accuracy of issuer-prepared schedules, or managing external confirmations).

[75] Other examples of individuals who work in the role of firm employees include leased personnel in firms with alternative practice structures and temporary contractors who work alongside other lead auditor personnel on the audit.

[76] 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.

[77] 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.

addition, some commenters asked whether the proposed term "referred-to auditor" is aligned with the term "principal accountant" used by the SEC.

The Board is considering retaining the definitions as originally proposed. The proposed definitions are designed for the requirements in the 2016 Proposal, which differ from those in ISA 600 and AU-C Section 600.[78] Further, the proposed definitions would not affect the applicability of SEC terms or rules to audits involving other auditors or referred-to auditors, including the definition of "principal accountant."

G. Other Matters

1. Replacing a Reference to AS 1205.12

The 2016 Proposal includes a conforming amendment to AS 2601, *Consideration of an Entity's Use of a Service Organization*. AS 2601.19 currently requires the auditor to "give consideration to the guidance in AS 1205.12." The proposed amendment to AS 2601.19 would replace the reference with a list of the procedures from AS 1205.12 that are now incorporated by reference, as follows:

> .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.

* * *

Some commenters asked whether the Board intended to change practice by placing the procedures discussed in AS 1205.12 directly in AS 2601. One commenter observed that auditors, for various reasons, rarely perform these procedures. Another commenter thought the proposed amendment may lead an auditor to presume that more is required than just "considering" performing the procedures.

The Board is considering retaining the requirement as originally proposed. The proposed amendment in the 2016 Proposal would not substantively change the existing

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[78] *See* Section II in Appendix 4 of the 2016 Proposal.

requirement, but rather preserve a referenced list of the procedures that are in a standard that is proposed to be superseded, aligning the language of the requirement more closely with PCAOB Rule 3101.[79]

2. Interim Reviews

The 2016 Proposal does not include amendments (other than conforming amendments) for engagements other than audits, but the Board requests comment on whether changes are needed for reviews of interim financial information that involve other auditors or referred-to auditors.[80]

The few commenters who responded to this question generally indicated that interim reviews in such audits should be addressed by the 2016 Proposal, but did not suggest any specific changes to standards. One commenter noted that any additional requirements should be scalable because the scope of an interim review is substantially less than that of an audit.

The Board, having evaluated the views and comments provided, is considering retaining conforming amendments to AS 4105 as proposed.

3. Investee Financial Statements Audited by Another Auditor

In some audits, auditors other than the lead auditor perform audit procedures on the financial statements of the company's investees (for example, in certain investments accounted for under the equity method). Existing AS 1205.14 discusses whether the auditor is in the position of a lead auditor ("principal auditor," as used in the terminology of AS 1205) and whether it may refer to the work and report of an auditor who 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.

Since the 2016 Proposal would supersede AS 1205, some commenters asked about the applicability of the proposed amendments and proposed standard to audits in which investee financial statements are audited by another accounting firm.

The 2016 proposing release discusses the applicability of AS 1201 and the proposed standard to situations involving investments accounted for under the equity method that are selected for testing pursuant to AS 2101. The proposal explains that it is intended neither to expand nor narrow the range of situations currently covered by

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[79] The auditor's responsibility to consider and the term "consider" are discussed in section (a)(3), *Responsibility to Consider,* of PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*.

[80] *See* proposed conforming amendments to AS 4105, *Reviews of Interim Financial Information,* in Appendix 3 of the 2016 Proposal.

AS 1201 and AS 1205.[81] The Board currently intends to retain the approach described in the 2016 Proposal. Specifically, AS 1201, as proposed (and as the Board is considering revising as discussed in this release), 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 the proposed standard AS 1206 would apply. This is consistent with the principle currently set forth in AS 1205.14.

With respect to other situations involving investee auditors, the auditor should follow direction in relevant PCAOB standards regarding obtaining sufficient appropriate audit evidence for investments whose valuation is based on the investee's financial condition or operating results.[82]

4. Communication to the Audit Committee

See AS 1301 on p. A1-10 in Appendix 1

The 2016 proposing release asks whether the lead auditor's communication to the audit committee about the other auditors and referred-to auditors should be more specific than is currently required by paragraph .10d of AS 1301, *Communications with Audit Committees*.

Some commenters indicated that the existing requirements are appropriate and need not be changed. One other commenter suggested requiring the lead auditor to communicate to those charged with governance issues arising from the other auditors' non-compliance with PCAOB standards, in certain situations.

The Board is not proposing to add the suggested requirement. Under AS 1301, the auditor is already required to communicate to the audit committee matters arising

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[81] *See* AS 2101.11 through .14, in Appendix 2 of this release, which set forth requirements for determining locations or business units at which audit procedures should be performed.

[82] *See, e.g.,* paragraph .28 of AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. AS 2503 would be superseded under *Proposed Auditing Standard – Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments To PCAOB Auditing Standards*, PCAOB Release No. 2017-002 (June 1, 2017). PCAOB Release No. 2017-002 describes the auditor's responsibilities for obtaining sufficient appropriate audit evidence in certain situations in which the valuation of an investment is based on the investee's financial condition or operating results. (*See* proposed amendments to AS 1105, *Audit Evidence,* in PCAOB Release No. 2017-002.)

from the audit that are significant to the oversight of the company's financial reporting process.[83]

Additionally, one commenter suggested modifying a proposed amendment to paragraph .10e of AS 1301 that would require the lead auditor to communicate to the audit committee certain matters relating to its sufficiency determination; the commenter recommended that this requirement apply only when significant parts of the audit are performed by other auditors.

The Board is considering revising the amendment so that the lead auditor is required to communicate to the audit committee the basis for determining the sufficiency of its participation only if significant parts of the audit are performed by other auditors or referred-to auditors.[84] This is intended to require communication about the sufficiency determination when it is most meaningful. As revised, the proposed amendment would essentially update terminology in existing AS 1301.10e by adding "referred-to auditors" to the phrase "if significant parts of the audit are to be performed by other auditors."

5. Further Conforming Amendments

If the Board adopts some or all of the amendments described in this release,[85] the Board would expect to include in the adopting release any necessary conforming amendments to auditing standards and rules of the Board that, at the time of adoption, are in effect or will be in effect. The 2016 Proposal included a number of conforming amendments to PCAOB auditing standards that were in effect at that time, but subsequently other amendments to Board standards were approved and became

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[83] This may include general information about the use of other auditors (AS 1301.10d) and other matters such as difficulties encountered in performing the audit (AS 1301.23), which might include difficulties related to the use of other auditors.

[84] *See* proposed AS 1301.10e in Appendix 1 and Appendix 2 of this release.

[85] In addition to the amendments described in the release, Appendix 1 shows technical revisions to the following: note to proposed AS 2101.B1 (to make the first sentence parallel with second), second note to proposed AS 2101.B4 (to substitute "such" for "the"), and proposed AS 2101.B6c (to use terms "lead auditor" and "audit documentation"). These revisions would improve readability and use terminology consistent with existing PCAOB standards. They would not change the substance of auditor responsibilities.

effective.[86] In addition, the Board recently adopted[87] and proposed[88] amendments that may become effective before adoption of the 2016 Proposal.

Question:

9. Is it clear how the proposed amendments and new standard (as revised by this release) relate to other amendments to auditing standards proposed or adopted by the Board since the 2016 Proposal?

IV. <u>Economic Considerations Relating to Certain Matters</u>

The 2016 Proposal includes an economic analysis that describes, among other things, the baseline for evaluating the economic impacts of the proposal, analyzes the

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[86] *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) (new Form AP and amendments to auditing standards to improve transparency regarding the engagement partner and other accounting firms that took part in the audit). The Board expects that further conforming amendments would, among other things, update references and terminology in Form AP.

[87] *See The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, PCAOB Release No. 2017-001 (June 1, 2017) (amendments to require the auditor to report new information about the audit and make the audit report more informative and relevant). *See also* SEC, *Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on the Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Departures From Unqualified Opinions and Other Reporting Circumstances, and Related Amendments to Auditing Standards*, Exchange Act Release No. 81187 (July 21, 2017), 82 FR 35396 (July 28, 2017) (SEC notice requesting comment on whether it should approve the amendments adopted by the PCAOB). If PCAOB Release No. 2017-001 is approved by the SEC, the Board expects that further conforming amendments would update references and terminology in AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and other standards, as applicable. In addition, the example report in proposed AS 1206 would be amended to conform with AS 3101.

[88] *See* PCAOB Release No. 2017-002 (proposed amendments to strengthen and enhance the requirements for auditing accounting estimates); *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*, PCAOB Release No. 2017-003 (June 1, 2017) (proposed amendments to increase audit attention in areas where a specialist is used and align requirements with PCAOB risk assessment standards).

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.

Commenters on the 2016 Proposal generally agreed with the analysis and did not raise comments unique to the economic analysis. The Board is soliciting comments on economic matters relating to the revisions and clarifications of the 2016 Proposal that are included in this supplemental request for comment. The Board also is requesting relevant information and empirical data regarding the revised proposal.

This section discusses the economic aspects of significant comments received on the 2016 Proposal, which pertain to the scalability of proposed amendments and the proposal's impact on smaller firms.

A. Scalability of Proposed Amendments

The 2016 Proposal would require the lead auditor to adjust (or "scale") its supervision of other auditors according to the complexity and the risk of material misstatement associated with the other auditors' work. Scalability is a characteristic of policy that typically refers to circumstances where requirements are general enough (e.g., principles-based) to be adapted effectively and efficiently under different facts and circumstances. Risk-based requirements are usually scalable because the necessary level of audit effort varies depending on the level of complexity and risk. Thus, risk-based requirements are likely to be relatively efficient (or at least not inefficient), because the auditor’s incentives and discretion are likely to result in costs being incurred primarily in circumstances involving a corresponding, and potentially larger, risk-mitigation benefit to investors.

As discussed in Sections III.A and III.B of this release, some commenters asked whether the lead auditor could adjust the extent of certain proposed planning and supervisory procedures based on the facts and circumstances of the audit. The commenters cautioned that the cost of implementing requirements which are not sufficiently scalable could be unjustifiably high for audit firms (and issuers, to the extent cost is passed on to them), without corresponding benefits to audit quality.

In light of commenters' concerns, the Board wishes to reiterate that the requirements for the lead auditor in the 2016 Proposal are designed to be scalable based on several factors, including complexity and risk. Under the 2016 Proposal, the lead auditor would be required to determine the extent of supervision of other auditors based on, among other things, the nature of work, and risk of material misstatement.[89]

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[89] *See* proposed AS 1201.B1, in Appendix 2 of this release, which states: "In performing the procedures described in this appendix the lead auditor should determine

Section III of this release expressly addresses the scalability of specific proposed requirements, including proposed revisions thereto.[90] For example, a proposed revision would allow the lead auditor (where appropriate, based on risk and other factors) to seek assistance from the first-tier other auditors in communicating certain information to the lower tiers of other auditors.[91] As another example, a proposed revision to .B2d of AS 1201 would require a summary memorandum from the other auditor, of which the form and content can vary.[92]

B. Potential Impact on the Competitiveness of Smaller Audit Firms

The 2016 Proposal indicates it would likely have the greatest economic impact on audits performed by smaller firms when they use other auditors. This is because smaller firms, compared with larger firms, (i) are less likely to perform the proposed procedures today; and (ii) generally lack the economies of scale to distribute the additional fixed costs over many audits. The proposing release also notes that the 2016 Proposal could decrease competition in the audit market for audits involving other auditors if smaller firms are less able to compete with larger firms.[93]

Some commenters were concerned that the proposal may put smaller audit firms at a competitive disadvantage compared to larger firms. One commenter indicated that, for smaller firms, complying with the proposed supervisory responsibilities may increase costs to such an extent that some smaller firms may exit the market for audits involving other auditors. Another commenter said that it would be harder for smaller firms than for larger firms to meet the proposed threshold for serving as lead auditor.

As noted in the previous sub-section, the proposed requirements are designed to be scalable and therefore applicable to audits of all sizes. Both the 2016 proposing release and this release discuss how the auditor could appropriately adjust the extent of its procedures to the circumstances of a particular audit. The Board believes that certain revisions to the 2016 Proposal that the Board is considering (and that are described in

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the extent of supervision of the other auditors' work in accordance with paragraph .06 of [AS 1201]." The factors described in AS 1201.06 include, among other things, the nature of the work and risks of material misstatement.

[90] *See, e.g.,* Section III.A.2, *Other Auditors' Compliance with Independence and Ethics Requirements*, Section III.A.3, *Other Auditors' Knowledge, Skill, and Ability*, Section III.B.2, *Instructing Other Auditors*, Section III.B.3, *Other Auditor Accountability and Duty to Provide a Written Report*, Section III.B.4, *Reviewing the Other Auditor's Work*, and Section III.B.5, *Multi-Tiered Audits*.

[91] *See* detailed discussion in Section III.B.5 of this release.

[92] *See* detailed discussion in Section III.B.3 of this release.

[93] *See* the 2016 Proposal, at 43.

this release) would further enhance the scalability of proposed supervision requirements. Further, adding a new sufficiency criterion for serving as lead auditor could address situations (which could be encountered by smaller firms) in which a location audited by the lead auditor does not comprise the greatest portion of the company's operations, but may still be important to the company.

As noted in the proposing release, the Board generally understands that smaller firms typically perform audits involving other auditors less often than larger firms do. If some smaller firms decide to discontinue performing audits involving other auditors, the Board expects that most, if not all, of those firms are likely to continue to conduct audits in other segments of the market, including private company audits, and issuer audits that do not involve other auditors.

C. Economic Impacts

As noted in the 2016 Proposal, the Board is mindful of the economic impacts of its standard setting. The 2016 Proposal included an economic analysis that discussed the benefits, costs, and potential unintended consequences of the proposed amendments.[94] The rule text revisions discussed in this release would make clarifying changes to address confusion expressed by commenters about certain aspects of the proposed rule text, or would make modest revisions to further carry out the policy approach of the 2016 Proposal. The Board has preliminarily concluded that the impact of the revisions discussed in this release relative to the 2016 Proposal would be negligible from an economic perspective – in other words, they would not significantly change the analysis set forth in the 2016 Proposal. The Board requests input from commenters about the potential economic impacts of these revisions.

Question:

10. Comment is requested on the matters discussed in this section. Would any revisions the Board is considering for adoption affect the scalability of PCAOB standards in this area? Would any have a significant effect on the competitiveness of smaller audit firms? Would the revisions significantly change the costs and benefits associated with the proposed changes discussed in the 2016 Proposal? Are there any unintended consequences that the Board should consider? Are there any other matters not addressed in this release the Board should consider in its economic analysis?

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[94] *See* Section IV of the 2016 Proposal.

V. Considerations for Audits of Emerging Growth Companies

The 2016 proposed amendments and proposed standard would apply to audits of issuers, as defined in Section 2(a)(7) of Sarbanes-Oxley. The 2016 proposing release discusses and seeks comment on whether the proposed amendments and proposed standard should apply to audits of emerging growth companies ("EGCs"), as defined in Section 3(a)(80) of the Securities Exchange Act of 1934 ("Exchange Act").[95]

No commenters opposed and several commenters expressly supported applying the proposed amendments and proposed standard to audits of EGCs. The Board continues to consider these comments. The Board also is seeking further comment, including any available empirical data, on how the revisions discussed in this release would affect EGCs and on whether the revised proposal would protect investors and promote efficiency, competition, and capital formation.[96]

VI. Application to Audits of Brokers and Dealers

The 2016 proposed amendments would apply to audits of brokers and dealers, as defined in Sections 110(3)-(4) of Sarbanes-Oxley. In the 2016 proposing release the PCAOB discusses and solicits comment on the applicability of the proposed amendments and proposed standard to audits of brokers and dealers.[97]

No commenters opposed and several commenters expressly supported applying the proposed amendments and proposed standard to audits of brokers and dealers. The Board continues to consider these comments. The Board also is seeking further comment on whether the revisions discussed in this release present specific issues with respect to audits of brokers and dealers.

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[95] *See* Section V of the 2016 Proposal. *See also* Section 103(a)(3)(C) of Sarbanes-Oxley, as added by Section 104 of the Jumpstart Our Business Startups ("JOBS") Act. Section 104 of the JOBS Act also provides that any rules of the Board requiring (1) mandatory audit firm rotation or (2) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an EGC. The Board believes the 2016 proposed amendments and proposed standard do not fall within either of these two categories.

[96] *See also* PCAOB, *White Paper on Characteristics of Emerging Growth Companies as of November 15, 2016* (Mar. 28, 2017), available on the PCAOB's website.

[97] *See* Section VI of the 2016 Proposal.

VII. Effective Date

The Board seeks comment on the amount of time auditors would need before the proposed new auditing standard and amendments become effective, if adopted by the Board and approved by the SEC. Specifically, the Board is considering whether compliance with an adopted standard and amendments should be required for audits of fiscal years beginning in the year after approval by the SEC (or for audits of fiscal years beginning two years after the year of SEC approval if that approval occurs in the fourth quarter).

VIII. Opportunity for Public Comment

The Board is seeking comments on the revisions to the proposed amendments and proposed standard that the Board is considering for adoption, and on all the other matters discussed in this release. The Board also is reopening the comment period for the 2016 Proposal, for any additional comments on other aspects of the 2016 Proposal. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data regarding the revised 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 or through the Board's website at 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 November 15, 2017.

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 those described in this release and in the 2016 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.

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On the 26th day of September, in the year 2017, 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

September 26, 2017

APPENDIX 1

Revisions to the 2016 Proposed Amendments Relating to the Performance of Audits Involving Other Auditors and Proposed Standard for Audits Involving Referred-to Auditors

This appendix presents revisions to amendments included in the 2016 Proposal for the following PCAOB standards:

- AS 2101, *Audit Planning*
- AS 1201, *Supervision of the Audit Engagement*
- AS 1015, *Due Professional Care in the Performance of Work*
- AS 1215, *Audit Documentation*
- AS 1301, *Communications with Audit Committees*

In addition, the appendix presents revisions to AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm,* as originally proposed. (This appendix does not present provisions of PCAOB standards that were included in the 2016 Proposal but that would not be revised by this supplemental request for comment.)

AS 2101, *Audit Planning*

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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: AS 1201 establishes requirements regarding supervision of the audit engagement, including the lead auditor's supervision of the work of other auditors. ~~The lead auditor must supervise, in accordance with AS 1201,[25] 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.[~~26~~25]
>
> ~~[25] AS 1201 establishes requirements regarding supervision of the audit engagement, including supervising the work of engagement team members.~~

[~~26~~25] 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:

a. ~~t~~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; and

b. The importance of the locations or business units for which the engagement partner's firm performs audit procedures in relation to the financial statements of the company as a whole, taking into account quantitative and qualitative factors.

In addition, the participation of the engagement partner's firm to serve as lead auditor ordinarily is not sufficient if the referred-to auditors, in aggregate, audit more than 50 percent of the company's assets or revenues.

.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,[~~27~~26] the lead auditor should determine each other auditor's compliance with the SEC independence requirements and PCAOB independence and ethics requirements by:

a. Gaining an understanding of each other auditor's ~~knowledge of~~ (1) process for determining compliance with the SEC independence requirements and PCAOB independence and ethics requirements and ~~their~~(2) experience in applying the requirements; and

b. Obtaining ~~a written representation~~ from each other auditor:

(1) A written description of all relationships between the other auditor and the audit client or persons in financial reporting oversight roles at the audit client that may reasonably be thought to bear on independence; and

(2) A written representation that it is, or is not, in compliance with SEC independence requirements and PCAOB independence and ethics requirements and, if it is not, a description of the nature of any non-compliance.

Note: The lead auditor's determination of each other auditor's compliance with the SEC independence requirements 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 an other auditor's description of its relationships that may reasonably be thought to bear on independence or a representation made by an other auditor regarding its compliance with the SEC independence requirements and PCAOB independence and ethics requirements, the lead auditor should perform additional procedures to determine the effect of ~~the~~ such information on the independence of the other auditor.

[~~27~~26] *See* AS 1206 for requirements for the lead auditor relating to the referred-to auditor's compliance with the SEC independence requirements 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.[~~28~~27]

[~~28~~27] *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. Inquire about other auditors' policies and procedures relating to the:

(1) Assignment of individuals to audits conducted under PCAOB standards; and

(2) Training of individuals who perform procedures on audits conducted under PCAOB standards, regarding the relevant financial reporting framework, PCAOB standards and rules, and SEC rules and regulations;

~~a.~~b. Gain an understanding of the knowledge, skill, and ability of the other auditors who assist the lead auditor with planning or supervision,[~~29~~28] 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.~~c. Determine that ~~it~~ the lead auditor is able to communicate with the other auditors and gain access to ~~their work papers~~ the other auditors' audit documentation.[~~30~~29]

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

~~29~~28 *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 of a multi-tiered engagement team.

~~30~~29 *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, *Supervision of the Audit Engagement*

* * *

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:[18]

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,[19] the identified risks of material misstatement,[20] and, if determined, the amount below which misstatements are clearly trivial and do not need to be accumulated[21] relevant to the work requested to be performed.

b. Obtain and review the other auditor's description ~~of the nature, timing, and extent~~ of the 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: The lead auditor should inform the other auditor of the necessary level of detail of the other auditor's description of audit procedures to be performed (*e.g.*, description of certain planned audit procedures for certain accounts and disclosures), which detail should be determined based on the necessary extent of supervision of the other auditor's work by the lead 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;[22]

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

> Note: The lead auditor should inform the other auditor of the necessary level of detail of the other auditor's information described in paragraphs .B2c and .B2d (*e.g.*, information for certain accounts and disclosures), which detail should be determined based on the necessary extent of supervision of the other auditor's work by the lead auditor.

e. Determine, based on a review of the documentation and ~~written report~~ summary memorandum 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.[23]

[18] Paragraph .B3 of this appendix describes how the requirements of this paragraph can be applied in multi-tiered engagement teams.

[19] *See* paragraphs .08–.10 of AS 2105, *Consideration of Materiality in Planning and Performing an Audit*.

[20] *See* requirements in AS 2110.49–.51 with respect to discussions among engagement team members in differing locations regarding risks of material misstatement.

[21] *See* AS 2810.10–.11.

[22] The specified documentation includes, but is not limited to, the documentation described in AS 1215.19.

[23] *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.[24] In these situations, the lead auditor may direct the first other auditor to perform the procedures in ~~paragraphs .B2b through .B2e~~paragraph .B2 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 should obtain, review, and retain a copy of the summary memorandum provided by the second other auditor to the first other auditor (paragraph .B2d). In addition, if the lead auditor directed the first other auditor to perform the procedures in paragraph .B2a, the lead auditor should obtain, review, and retain a copy of the communications required by paragraph .B2a or equivalent documentation of the first other auditor's communication. The lead auditor remains responsible for ~~informing directly both the first other auditor and second other auditor of the matters in paragraph .B2a~~obtaining, reviewing, and retaining the documentation required by AS 1215.19.

[24] The requirements of this paragraph also apply to audits in which there are multiple second other auditors.

* * *

AS 1015, *Due Professional Care in the Performance of Work*

.01 Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.

.02 The statement in the preceding paragraph requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting.

> Note: For audits that involve other auditors,[1] the other auditors are responsible for performing their work with due professional care.

[1] The term "other auditors," as used in this standard, has the same meaning as in Appendix A of AS 1201.

.03 *Cooley on Torts*, a legal treatise, describes the obligation for due care as follows:

> Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is

requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.[2]

[2] D. Haggard, *Cooley on Torts*, 472 (4th ed., 1932).

.04 The matter of due professional care concerns what the independent auditor does and how well he or she does it. The quotation from *Cooley on Torts* provides a source from which an auditor's responsibility for conducting an audit with due professional care can be derived. The remainder of the section discusses the auditor's responsibility in the context of an audit.

.05 An auditor should possess "the degree of skill commonly possessed" by other auditors and should exercise it with "reasonable care and diligence" (that is, with due professional care).

.06 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. The engagement partner should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team.[4]

[4] *See* AS 1201, *Supervision of the Audit Engagement.*

* * *

AS 1215, *Audit Documentation*

*** * ***

Retention of and Subsequent Changes to Audit Documentation

*** * ***

~~.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[4A] 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.~~

~~[4A] The term "lead auditor," as used in this paragraph, has the same meaning as in Appendix A of AS 1201.~~

*** * ***

AS 1301, *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;[9]

b. The extent to which the auditor plans to use the work of the company's internal auditors in an audit of financial statements;[10]

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;[11]

d. The names, locations, and planned responsibilities[12] of other 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;[12A] and

e. 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, if significant parts of the audit are to be performed by other auditors or referred-to auditors.[13]

[9] *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.

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

[11] *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.

[12] *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 in multi-location engagements.

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

[13] *See* AS 2101.B2 and .B3, which establish requirements regarding serving as the lead auditor.

*** * ***

Proposed AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*

*** * ***

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

*** * ***

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

a. Independent under the~~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.

*** * ***

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

* * *

~~d. The representation~~s ~~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~~

* * *

~~b.~~d. In situations when ~~T~~the financial statements of the company's business unit audited by the referred-to auditor were prepared using ~~the same~~ a financial reporting framework ~~as~~ that differs from the financial reporting framework used to prepare the company's financial statements, (1) either the lead auditor or the referred-to auditor has audited the conversion adjustments and (2) the lead auditor indicates in its report which auditor (the lead auditor or the referred-to auditor) has taken responsibility for auditing the conversion adjustments.~~;~~

* * *

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~~qualifications of the referred-to auditor or concerns about whether the referred-to auditor's audit was in accordance with PCAOB standards), the lead auditor should:

* * *

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:

* * *

> Note: Appendix B includes ~~an~~ examples of reporting by the lead auditor ~~indicating the division of responsibility when making reference to the audit and report of the referred-to auditor~~.

* * *

APPENDIX B – Examples of Reporting by the Lead Auditor Indicating the Division of Responsibility When Making Reference to the Audit and Report of the Referred-to Auditor

* * *

Alternative Paragraphs When the Financial Statements Audited by the Referred-to Auditor were Prepared using a Financial Reporting Framework that Differs from the Framework Used to Prepare the Financial Statements Audited by the Lead Auditor

Example 1: Conversion Adjustments Audited by Lead Auditor

> We did not audit the financial statements and internal control over financial reporting of B Company, a wholly owned subsidiary. The financial statements of B Company prepared under [name of financial reporting framework used by B Company] 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 under [name of financial reporting framework used by B Company] and its internal control over financial reporting, are based solely on the report of Firm ABC. The financial statements of B Company under accounting principles generally accepted in the United States of America 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 ended December 31, 20X3, 20X2, and 20X1, respectively. We have audited the adjustments to the financial statements of B Company to conform those financial statements to accounting principles generally accepted in the United States of America.

Example 2: Conversion Adjustments Audited by Referred-to Auditor

> We did not audit the financial statements and internal control over financial reporting of B Company, a wholly owned subsidiary. The financial statements of B Company prepared under [name of financial reporting framework used by B Company], the adjustments to conform those financial statements to accounting principles generally accepted in the United States of America, and internal control over financial reporting of B Company 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 under accounting principles generally accepted in the United States of America and its internal control over financial reporting, are based solely on the report of Firm ABC. The financial statements of B Company under accounting principles generally accepted in the United States of America 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 ended December 31, 20X3, 20X2, and 20X1, respectively.

APPENDIX 2

Cumulative Potential Amendments to Existing PCAOB Standards Relating to the Performance of Audits Involving Other Auditors

This appendix presents the cumulative potential amendments (those in the 2016 Proposal, revised by this supplemental request for comment) for the following PCAOB standards:

- AS 2101, *Audit Planning*
- AS 1201, *Supervision of the Audit Engagement*
- AS 1015, *Due Professional Care in the Performance of Work*
- AS 1215, *Audit Documentation*
- AS 1301, *Communications with Audit Committees*

These provisions are presented as if existing PCAOB standards were amended by the 2016 Proposal and this supplemental request for comment. Language that would be deleted is ~~struck through~~. Language that would be added is <u>underlined</u>. (This appendix does not present provisions of PCAOB standards that were included in the 2016 Proposal but that would not be revised by this supplemental request for comment.)

AS 2101, *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**[1] 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.

[1] 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.[2]

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

[2] 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,[3]

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, *Communications with Audit Committees*.

[3] 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, 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,[5] risk, and, in integrated audits, other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee[6] 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.

5 AS 2105, *Consideration of Materiality in Planning and Performing an Audit.*

6 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,[7]

b. The factors that are significant in directing the activities of the engagement team,[8]

c. The results of preliminary engagement activities[9] 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.[10]

7 *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.

8 *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.

9 Paragraph .06 of this standard.

10 *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;[11]

b. The planned nature, timing, and extent of tests of controls and substantive procedures;[12] and

c. Other planned audit procedures required to be performed so that the engagement complies with PCAOB standards.

11 AS 2110, *Identifying and Assessing Risks of Material Misstatement.*

12 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,[13] 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.

[13] 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;[14]

b. The materiality of the location or business unit;[15]

c. The specific risks associated with the location or business unit that present a reasonable possibility[16] 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[17] for considerations when a company has multiple locations or business units.

[14] Paragraph .66 of AS 2401, *Consideration of Fraud in a Financial Statement Audit*.

[15] AS 2105.10 describes the consideration of materiality in planning and performing audit procedures at an individual location or business unit.

[16] 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.

[17] 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.[18] I~~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[18] 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.

[18] ~~For integrated audits, *see also* AS 2201.C8–.C11.~~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.[19]

[19] *See also* paragraph .03 of AS 2820, *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[20] 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, *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.[21]

[20] *See* paragraph (a)(ii) in PCAOB Rule 1001, *Definitions of Terms Employed in Rules*.

[21] *See* AS 1210.

.A4 Lead auditor –

a. The registered public accounting firm[22] issuing the auditor's report on the company's financial statements and, if applicable, internal control over financial reporting; and

b. The engagement partner and other engagement team members who: (1) are partners, principals, shareholders, or employees of the registered public accounting firm issuing the auditor's report and (2) assist the engagement partner in fulfilling his or her planning or supervisory responsibilities on the audit pursuant to AS 2101 or AS 1201.[23]

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

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

[23] *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[24] 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.

[24] 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: AS 1201 establishes requirements regarding supervision of the audit engagement, including the lead auditor's supervision of 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.[25]

[25] 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:

a. 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, in comparison with the portions for which the other auditors perform audit procedures or the portions audited by the referred-to auditors; and

b. The importance of the locations or business units for which the engagement partner's firm performs audit procedures in relation to the financial statements of the company as a whole, taking into account quantitative and qualitative factors.

In addition, the participation of the engagement partner's firm to serve as lead auditor ordinarily is not sufficient if the referred-to auditors, in aggregate, audit more than 50 percent of the company's assets or revenues.

.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,[26] the lead auditor should determine each other auditor's compliance with the SEC independence requirements and PCAOB independence and ethics requirements by:

a. Gaining an understanding of each other auditor's (1) process for determining compliance with the SEC independence requirements and PCAOB independence and ethics requirements and (2) experience in applying the requirements; and

b. Obtaining from each other auditor:

(1) A written description of all relationships between the other auditor and the audit client or persons in financial reporting oversight roles at the audit client that may reasonably be thought to bear on independence; and

(2) A written representation that it is, or is not, in compliance with SEC independence requirements and PCAOB independence and ethics requirements and, if it is not, a description of the nature of any non-compliance.

Note: The lead auditor's determination of each other auditor's compliance with the SEC independence requirements 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 an other auditor's description of its relationships that may reasonably be thought to bear on independence or a representation made by an other auditor regarding its compliance with the SEC independence requirements and PCAOB independence and ethics requirements, the lead auditor should perform additional procedures to determine the effect of such information on the independence of the other auditor.

[26] *See* AS 1206 for requirements for the lead auditor relating to the referred-to auditor's compliance with the SEC independence requirements 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.[27]

[27] *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. Inquire about other auditors' policies and procedures relating to the:

   (1) Assignment of individuals to audits conducted under PCAOB standards; and

   (2) Training of individuals who perform procedures on audits conducted under PCAOB standards, regarding the relevant financial reporting framework, PCAOB standards and rules, and SEC rules and regulations;

b. Gain an understanding of the knowledge, skill, and ability of the other auditors who assist the lead auditor with planning or supervision,[28] 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

c. Determine that the lead auditor is able to communicate with the other auditors and gain access to the other auditors' audit documentation.[29]

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

[28] *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 of a multi-tiered engagement team.

[29] *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, *Supervision of the Audit Engagement*

Introduction

.01 This standard establishes requirements regarding supervision of the audit engagement, including supervising the work of **engagement team**[1] members.

[1] 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**~~[1]~~ 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,[2] ~~other auditors,[3]~~ internal auditors,[4] and others who are involved in testing controls~~.~~;[5] and dividing responsibility with another accounting firm.[5A] Paragraphs .05–.06 of this standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.[6]

> 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.

[2] AS 1210, *Using the Work of a Specialist*.

~~[3] AS 1205, *Part of the Audit Performed by Other Independent Auditors*.~~

[4] AS 2605, *Consideration of the Internal Audit Function*.

[5] Paragraphs .16–.19 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[5A] *See* AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*.

[6] *See also* paragraph .06 of AS 1015, *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,[7] 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,[8] 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;[9]

> 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.[10]

[7] AS 1015.06 and paragraph .05 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, establish requirements regarding the appropriate assignment of engagement team members.

[8] AS 2110, *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.

[9] *See, e.g.*, paragraph .15 of AS 2101, *Audit Planning*, AS 2110.74, and paragraphs .20–.23 and .35–.36 of AS 2810, *Evaluating Audit Results*.

[10] AS 2810 describes the auditor's responsibilities for evaluating the results of the audit, and AS 1215, *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;[11]

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.[12]

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.[13]

[11] AS 2110.10.

[12] *See also* AS 2301.05a and AS 1015.06.

[13] 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[14] 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, *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.[15]

[14] *See* paragraph (a)(ii) in PCAOB Rule 1001, *Definitions of Terms Employed in Rules*.

[15] *See* AS 1210.

.A4 Lead auditor –

a. The registered public accounting firm[16] 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.[17]

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

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

[17] *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:[18]

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,[19] the identified risks of material misstatement,[20] and, if determined, the amount below which misstatements are clearly trivial and do not need to be accumulated[21] relevant to the work requested to be performed.

b. Obtain and review the other auditor's description of the 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: The lead auditor should inform the other auditor of the necessary level of detail of the other auditor's description of audit procedures to be performed (*e.g.*, description of certain planned audit procedures for certain accounts and disclosures), which detail should be determined based on the necessary extent of supervision of the other auditor's work by the lead 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;[22]

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

Note: The lead auditor should inform the other auditor of the necessary level of detail of the other auditor's information described in paragraphs .B2c and .B2d (*e.g.*, information for certain accounts and disclosures), which detail should be determined based on the necessary extent of supervision of the other auditor's work by the lead auditor.

e. Determine, based on a review of the documentation and summary memorandum 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.[23]

[18] Paragraph .B3 of this appendix describes how the requirements of this paragraph can be applied in multi-tiered engagement teams.

[19] *See* paragraphs .08–.10 of AS 2105, *Consideration of Materiality in Planning and Performing an Audit*.

[20] *See* requirements in AS 2110.49–.51 with respect to discussions among engagement team members in differing locations regarding risks of material misstatement.

[21] *See* AS 2810.10–.11.

[22] The specified documentation includes, but is not limited to, the documentation described in AS 1215.19.

[23] *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.[24] In these situations, the lead auditor may direct the first other auditor to perform the procedures in paragraph .B2 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 should obtain, review, and retain a copy of the summary memorandum provided by the second other auditor to the first other auditor (paragraph .B2d). In addition, if the lead auditor directed the first other auditor to perform the procedures in paragraph .B2a, the lead auditor should obtain, review, and retain a copy of the communications required by paragraph .B2a or equivalent documentation of the first other auditor's communication. The lead auditor remains responsible for obtaining, reviewing, and retaining the documentation required by AS 1215.19.

[24] The requirements of this paragraph also apply to audits in which there are multiple second other auditors.

* * *

AS 1015, *Due Professional Care in the Performance of Work*

.01 Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.

.02 The statement in the preceding paragraph requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting.

> Note: For audits that involve other auditors,[1] the other auditors are responsible for performing their work with due professional care.

[1] The term "other auditors," as used in this standard, has the same meaning as in Appendix A of AS 1201.

.03 *Cooley on Torts*, a legal treatise, describes the obligation for due care as follows:

> Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith

and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.[2]

[2] D. Haggard, *Cooley on Torts*, 472 (4th ed., 1932).

.04 The matter of due professional care concerns what the independent auditor does and how well he or she does it. The quotation from *Cooley on Torts* provides a source from which an auditor's responsibility for conducting an audit with due professional care can be derived. The remainder of the section discusses the auditor's responsibility in the context of an audit.

.05 An auditor should possess "the degree of skill commonly possessed" by other auditors and should exercise it with "reasonable care and diligence" (that is, with due professional care).

.06 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. The engagement partner should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team.[4]

[4] *See* AS 1201, *Supervision of the Audit Engagement.*

*** * ***

AS 1215, *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 <u>other offices of the firm and </u>other auditors[3A] ~~(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.[4]

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

[4] 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*.~~

* * *

AS 1301, *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;[9]

b. The extent to which the auditor plans to use the work of the company's internal auditors in an audit of financial statements;[10]

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;[11]

d. The names, locations, and planned responsibilities[12] 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;[12A] 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~~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, if significant parts of the audit are to be performed by other auditors or referred-to auditors.[13]

[9] *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.

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

[11] *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.

[12] *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 in~~volving~~ multi-location engagements.

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

[13] *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.

APPENDIX 3

This appendix presents proposed AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, modified for the revisions presented in this supplemental request for comment.

Proposed AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*

Introduction

.01 This standard establishes requirements for the **lead auditor**[1] regarding dividing responsibility for the audit of the company's financial statements[2] and, if applicable, internal control over financial reporting with a **referred-to auditor**.[3]

> Note: AS 2101, *Audit Planning*, establishes requirements regarding serving as the lead auditor.[4]
>
> 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

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[1] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[2] 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.

[3] For integrated audits, *see* also paragraphs .C8 through .C11 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[4] *See* paragraphs .B2 and .B3 of AS 2101.

regarding the supervision of the work of the engagement team members, including those not employed by the lead auditor.[5]

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[6] audited by the referred-to auditor into the company's financial statements.[7] 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 obtain a written representation from the referred-to auditor that the referred-to auditor is:

a. Independent under the 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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[5] The term "engagement team," as used in this standard, has the same meaning as in Appendix A of AS 2101.

[6] The term "business units" includes subsidiaries, divisions, branches, components, or investments.

[7] *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;[8]

b. 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;

c. 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 statements and, if applicable, internal control over financial reporting, is registered pursuant to the rules of the PCAOB;[9] and

d. In situations when the financial statements of the company's business unit audited by the referred-to auditor were prepared using a financial reporting framework that differs from the financial reporting framework used to prepare the company's financial statements, (1) either the lead auditor or the referred-to auditor has audited the conversion adjustments and (2) the lead auditor indicates in its report which auditor (the lead auditor or the referred-to auditor) has taken responsibility for auditing the conversion adjustments.

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[8] AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances* (pending SEC approval), apply 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.

[9] *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."

.07 In situations in which the lead auditor is unable to divide responsibility with another accounting firm (*e.g.*, due to concerns about the qualifications of the referred-to auditor or concerns about whether the referred-to auditor's audit was in accordance with PCAOB standards), 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.[10]

c. Withdraw from the engagement.

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;

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[10] 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 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances* (pending SEC approval), 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)."

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;[11] 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 examples of reporting by the lead 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.[12]

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

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[11] 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.

[12] *See, e.g.*, AS 2201.C10.

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[13] 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.[14]

.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[15] 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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[13] *See* paragraph (r)(i) in PCAOB Rule 1001, *Definitions of Terms Employed in Rules*, which defines the term registered public accounting firm.

[14] *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."

[15] The term "business units" includes subsidiaries, divisions, branches, components, or investments.

APPENDIX B – Examples 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 are examples 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[16]

[*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 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

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[16] *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, PCAOB Release No. 2017-001 (June 1, 2017) (pending SEC approval) finalized a number of changes to the auditor's report.

relate to the amounts included for B Company and its internal control over financial reporting, are based solely on the report of Firm ABC.[17]

[*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.

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[17] The end of this appendix presents alternatives to this paragraph for situations in which the financial statements audited by the referred-to auditor were prepared using a financial reporting framework that differs from the framework used to prepare the financial statements audited by the lead auditor.

[*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*]

Alternative Paragraphs When the Financial Statements Audited by the Referred-to Auditor were Prepared using a Financial Reporting Framework that Differs from the Framework Used to Prepare the Financial Statements Audited by the Lead Auditor

Example 1: Conversion Adjustments Audited by Lead Auditor

We did not audit the financial statements and internal control over financial reporting of B Company, a wholly owned subsidiary. The financial statements of B Company prepared under [name of financial reporting framework used by B Company] 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 under [name of financial reporting framework used by B Company] and its internal control over financial reporting, are based solely on the report of Firm ABC. The financial statements of

B Company under accounting principles generally accepted in the United States of America 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 ended December 31, 20X3, 20X2, and 20X1, respectively. We have audited the adjustments to the financial statements of B Company to conform those financial statements to accounting principles generally accepted in the United States of America.

Example 2: Conversion Adjustments Audited by Referred-to Auditor

We did not audit the financial statements and internal control over financial reporting of B Company, a wholly owned subsidiary. The financial statements of B Company prepared under [name of financial reporting framework used by B Company], the adjustments to conform those financial statements to accounting principles generally accepted in the United States of America, and internal control over financial reporting of B Company 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 under accounting principles generally accepted in the United States of America and its internal control over financial reporting, are based solely on the report of Firm ABC. The financial statements of B Company under accounting principles generally accepted in the United States of America 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 ended December 31, 20X3, 20X2, and 20X1, respectively.