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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

PCAOB Rulemaking Docket Matter No. 042: *Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard – Dividing Responsibility for the Audit with Another Accounting Firm*

Dear Ms. Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2016-002, *Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard – Dividing Responsibility for the Audit with Another Accounting Firm* (referred to as the proposed amendments and the proposed standard, respectively, and collectively as the Proposal).

The Board has requested public comment on the Proposal that is intended to improve audit quality and investor protection through enhancements to the current requirements related to the lead auditor's responsibilities concerning 1) the supervision of other auditors and 2) referred-to auditors. Overall, we support the Board's initiative to further strengthen audit quality and investor protection with respect to audits that involve other auditors and referred-to auditors.

Overview

KPMG agrees with the PCAOB's intended goal to provide a more uniform, risk-based approach to supervision in audits that involve other auditors. We agree that superseding Auditing Standard (AS) 1205, *Part of the Audit Performed by Other Independent Auditors*, and amending AS 2101, *Audit Planning*, and AS 1201, *Supervision of the Audit Engagement*, which requires a level of supervision by the lead auditor of other auditors commensurate with the associated risks, is useful in harmonizing the standards. In current practice, many of the larger audit firms, such as KPMG, have implemented changes to their methodology to expand lead auditor responsibilities to address risks associated with relying on the work of other auditors, which is consistent with the approach taken by the PCAOB.

Consistent with the Board's views, we believe that when parts of the audit are performed by other auditors, encompassing those responsibilities and requirements under AS 1201 will further enhance audit quality and strengthen investor protection. However, we believe the Proposal risks falling short of the PCAOB's goals by not consistently applying the concept of a risk-based approach. In our view, the Proposal goes too far in requiring specific procedures to be performed by the lead auditor, regardless of risk. In addition to our concerns over the nature and extent of the prescriptive requirements, we also suggest the Board clarify certain aspects included in the proposed amendments and proposed standard.

Below we have expanded on our observations on the Proposal that we deem to be key and require further consideration by the Board.

Reliance on a Firm's Quality Control System

We do not believe the proposed amendments and proposed standard sufficiently consider an audit firm's system of quality control and the benefits that accrete to the engagement when the system of quality control is effective. To illustrate this, we point to the PCAOB Quality Control Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (QC 20), which requires firms to establish a system of quality control that ensures "its personnel comply with the professional standards applicable to its accounting and auditing practice."[1] The system of quality control is defined as "a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality."[2] Required elements of a system of quality control include: 1) independence, integrity, and objectivity; 2) personnel management; 3) acceptance and continuance of clients and engagements; 4) engagement performance; and 5) monitoring. QC 20 continues by stating "[t]he system of quality control should provide the firm with reasonable assurance that the segments of the firm's engagements performed by its foreign offices or by its domestic or foreign affiliates or correspondents are performed in accordance with professional standards in the United States when such standards are applicable."[3]

Therefore, to comply with QC 20, audit firms have established a quality control system that is used when assigning audit engagement responsibilities to the lead audit partner, engagement managers and engagement quality reviewer (EQR), among others, to conduct those audits, and these systems support the quality of work performed by the engagement team and EQR. As such, a risk-based supervisory approach should take into consideration a firm's evaluation of the system of quality control. To perform this assessment, the lead auditor would evaluate information that is made available to them (e.g., internal/external reports on a firm's and/or individual's inspection results, information on compliance with training or other requirements, etc.) as well as make inquiries of the other auditors regarding the existence of any exceptions to the quality controls on which the lead auditor is relying (e.g., Have the individuals on the engagement team been subject to quality performance reviews as scheduled?, What were the results of the individual's latest performance evaluation?, etc.). Based on this evaluation of the firm's system of quality control, in conjunction with the lead auditor's consideration of the risks presented by the operations of the foreign location and evaluation of the professional competency of the other auditor (partner and manager), the lead auditor would determine the extent of supervision required of the other auditor. For example, if Firm A is determined to be the lead auditor and Firm B, a network firm, reports to Firm A, Firm A should determine the level of supervision required based on its assessment of the knowledge, skill, and ability of Firm B's engagement partner (and EQR as applicable) and engagement managers, which might be

[1] PCAOB Quality Control Section 20, paragraph .03
[2] Ibid
[3] PCAOB Quality Control Section 20, paragraph .06

accomplished through Firm A's assessment of Firm B's system of quality control. Based on that assessment, Firm A is able to determine the extent of supervision that is required of Firm B's engagement partner (and EQR as applicable) and engagement managers responsible for the local audit.

While lead auditors would retain responsibility for the quality of their audit engagements, recognizing and enabling them to rely on the system of quality control allows them to fulfill their responsibilities more effectively and efficiently, and would not diminish audit quality. We encourage the Board to consider revising the Proposal to include this element as well as recommend that the Board provide implementation guidance or illustrative examples of when and under what circumstances it would be appropriate to place such reliance, as well as the level of documentation that would be expected to demonstrate the appropriateness of such reliance.

To demonstrate the benefits achieved by incorporating such reliance on the system of quality control into the proposed amendments, the lead auditor would be able to apply professional judgment when determining the nature and extent of supervision, and specifically which working papers are necessary for him/her to review. This would eliminate duplicated efforts of review (i.e., unnecessary review of a working paper by both the lead auditor and other auditor) when it has been concluded that the other auditor may be more appropriately positioned to review certain working papers due to their knowledge and experience at the local company or business unit and the risk associated with that audit area.

Lastly, if the system of quality control is not considered, the result may include a significant increase in audit costs with uncertain meaningful additional direct or indirect benefit to audit quality or investor protection. Based on the above observations, we recommend the Board harmonize the Proposal with its quality control standards and allow lead auditors to assess and place reliance on these systems of quality control, when appropriate.

Determination of the Lead Auditor, Including Concluding on Sufficient Participation

Additional guidance is needed to clarify the factors an auditor should consider when determining whether its own participation is sufficient to enable it to issue the auditor's report on the company's financial statements and therefore serve as the "lead auditor." Otherwise, various interpretations of the Proposal could occur, which could lead to diversity in practice. For example, the Proposal is not clear if the determination is based on plurality of risk or majority of risk. Based on the examples on pages A4-15 – 18 of the Proposal, it appears to be based on plurality of risk, and we believe it would be beneficial to explicitly indicate such in the final amendments, if that is the PCAOB's intent. In addition, paragraph B2 of AS 2101 indicates that the determination of sufficiency "should take into account the risks of material misstatement associated with the portion of the company's financial statements for which the engagement partner's firm performs audit procedures …" We believe clarification of the phrase "performs audit procedures" is needed, because we can envision various scenarios where it would be appropriate to consider one firm to be the lead auditor, even though most, if not all, of the back office accounting function may be located in a different country and audited by a different firm.

Direct and active supervision and oversight of one firm's engagement team by another firm should be a factor, we believe, in assessing sufficiency of participation, but we do not know whether those supervision and oversight activities are contemplated by the PCAOB to be included within the "performs audit procedures" phrase.

Furthermore, the proposed amendments require the EQR to evaluate the lead 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."[4] Under the current standard (specifically, AS 1220, *Engagement Quality Review*), the EQR "should evaluate the significant judgments made by the engagement team…", which would include evaluating whether his/her firm should act as lead auditor if significant judgment was required to be exercised. Determining the ability to act as the lead auditor does not always require significant judgment. Therefore, we do not believe this proposed amendment is necessary, and we recommend the PCAOB not change the current requirements of AS 1220.

Specific Performance Requirements for the Lead Auditor

Although KPMG agrees with the PCAOB that the lead auditor should perform procedures to evaluate the knowledge, skills, and ability of other auditors, more specific guidance is requested to understand the nature and extent of this assessment. For example, it is unclear if inquiry of the other auditor is sufficient to gain an understanding of the other auditor's skills and experience. Further, as it relates to other auditors from out-of-network firms, it may be challenging to obtain evidence of skills and experience beyond inquiry. As such, we suggest that the proposed amendments limit the required procedures regarding the assessment of the knowledge, skills, and ability of the other auditors to inquiry. If more robust procedures are intended by the Board, we believe that the Board should be more specific as to the nature and extent of such procedures. In addition, we believe the PCAOB should clarify that it would be appropriate for these procedures to be performed at the engagement team level, rather than at an individual team member level. Under this approach, the other auditor's engagement partner could confirm to the lead auditor on behalf of his/her firm and engagement team members, which is consistent with current practice.

In addition, as noted by the Board as a possible unintended consequence of the proposed amendments, requiring the lead auditor to perform additional supervisory responsibilities could result in the lead auditor inefficiently allocating audit resources and incorrectly focusing his/her attention on an area of the audit with less risk[5], which could result in a material misstatement remaining undetected in a higher risk area. Although this may be mitigated through the application of a risk-based approach, the relatively prescriptive requirements of the Proposal undercuts an auditor's ability to make risk-based assessments. Instead, if the lead auditor was permitted to consider the system of quality control, as discussed above, and then determine the extent of supervision required based on risk (including the risk presented by the other auditor's

[4] Page A1-25 of the Proposal.
[5] Page 41 of the Proposal.

system of quality control, the individual auditors' competencies, and the audit work to which they are assigned), such concerns regarding the lead auditor incorrectly focusing on lower risk areas would be reduced.

Furthermore, it is usually necessary to complete the procedures over work performed by other auditors closer to the end of the audit so that the other auditors have a sufficient amount of time to effectively perform their required procedures. This imposes constraints on the lead auditor in terms of audit resource allocation and its ability to perform an effective review/supervision of the other auditor's work when up against a filing deadline, while also performing other completion requirements in advance of the filing deadline, such as communications with those charged with governance, assessment of uncorrected misstatements or internal control deficiencies, and drafting of critical audit matters.[6] In such circumstances, audit quality could be hindered, which would jeopardize the overall goal of the PCAOB to enhance audit quality and improve investor protection.

Lastly, imposing prescriptive requirements related to the lead auditor's responsibilities over other auditors also goes beyond the Board's intentions to "provide additional direction" as stated on page 20 of the Proposal. "Additional direction" generally indicates a path for the auditor to take but allowing him/her to determine the specific approach or means to completing that path, which we support. Although we agree that additional direction is necessary, we propose the Board consider using implementation guidance or illustrative examples, as appropriate, to illustrate the risk-based approach, and not impose prescriptive requirements.

Therefore, based on the above comments, we encourage the Board to revisit the specific requirements related to the supervision of other auditors. If the Board does not believe consistency in application of the amendments is achievable through implementation guidance or illustrative examples, we propose the specific requirements be as limited as possible so as to not deteriorate the foundation of the Proposal as risk-based.

AS 1206

As it relates to the PCAOB's proposed standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, KPMG accepts the views of the PCAOB on dividing responsibility of the audit with another audit firm and is not opposed to the issuance of a separate standard to address this matter.

We do request clarification of the Board's expectation of the lead auditor to comply with paragraph .06c of AS 1206. As currently drafted, the lead auditor is to inquire if the referred-to auditor "knows the relevant requirements of the applicable financial reporting framework,

[6] PCAOB Release No. 2016-003, *Proposed Auditing Standard - The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, proposes critical audit matters be communicated in the auditor's report. This assumes the concept of critical audit matters, in some form, is eventually made effective.

standards of the PCAOB, and financial reporting requirements of the SEC." However, on page A4-52 of the Proposal, it indicates that to comply with this requirement, the lead auditor could "discuss the referred-to auditor's prior and current work experience that may be relevant to evaluating the professional competence" of the referred-to auditor. Evaluating the professional competence of the referred-to auditor appears to go beyond what is required under paragraph .06c, as currently drafted, and therefore, we recommend the Board revise the example procedures described on page A4-52. However, if it is the Board's intention to have the lead auditor evaluate the knowledge, skills, and ability of the referred-to auditor to the extent required of other auditors in the proposed amendments, which we do not believe is necessary given the division of responsibility, we suggest the Board revise the proposed standard. We also propose the Board allow the lead auditor to rely on a firm's system of quality control, as discussed above, when assessing a referred-to auditor in accordance with paragraph .06c of AS 1206.

Other

With the increased requirements over other auditors and referred-to auditors under the proposed amendments and proposed standard, respectively, we believe that the PCAOB should consider if a requirement and/or guidance is needed with respect to the expectation that other auditors and referred-to auditors, if such firms are registered with the PCAOB, would cooperate with the lead auditor's efforts to comply with the requirements of the issued amendments and new standard. A risk exists whereby the lead auditor may not be able to complete the required procedures because of a lack of cooperation and therefore would be required to issue a disclaimer of opinion due to a scope limitation or withdraw from the engagement. For example, Audit Firm A audits Company X, a biotechnology company. Audit Firm B audits Company Z, which has an equity investment in Company X that is material to Company Z. There is a risk that Audit Firm A may not respond or cooperate with Audit Firm B's requests to assess knowledge, skills, and ability or provide access to working papers for review, which would prevent Audit Firm B from being able to issue an unqualified opinion, due to the scope limitation. If cooperation is not required, disclaimer opinions or forced withdrawals could result, which would hinder the PCAOB's goals of increased audit quality, accountability by the lead auditor, and increased information to investors.

Applicability and Effective Date

Applicability

We are not aware of any strong arguments that would indicate that emerging growth companies and broker dealers should be excluded from the Proposal. We, therefore, agree with the Board that the Proposal should apply to audits of these types of entities.

Effective date

A sufficient amount of time will be necessary to evaluate and implement any changes required to our audit methodology arising from the new guidance. In addition, we will need to develop and provide training on the final amendments and new standard to all of our audit professionals.

Therefore, we would recommend that the effective date of the final amendments and new standard should be no earlier than two years after the SEC's approval of the final amendments and new standard.

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We appreciate the Board's careful consideration of our comments and observations, and support the Board's efforts to increase accountability of the lead auditor and improve audit quality and investor protection. If you have any questions regarding our comments included in this letter, please do not hesitate to contact George Herrmann ((212) 909-5779 or gherrmann@kpmg.com) or Rob Chevalier ((212) 909-5067 or rchevalier@kpmg.com).

Very truly yours,

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