

**A FIRM'S SYSTEM OF QUALITY CONTROL**

**AND OTHER PROPOSED AMENDMENTS TO  
PCAOB STANDARDS, RULES, AND FORMS**

PCAOB Release No. 2022-006  
November 18, 2022

PCAOB Rulemaking  
Docket Matter No. 046

**Summary:** The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is proposing a new quality control standard, together with other amendments to PCAOB standards, rules, and forms. The proposal would:

- (1) supersede current PCAOB quality control standards with an integrated, risk-based standard, QC 1000, *A Firm's System of Quality Control*, that would apply to all registered public accounting firms;
- (2) create reporting requirements on quality control matters and a new, non-public reporting form, Form QC;
- (3) expand the auditor's responsibility to respond to deficiencies on completed engagements under an amended and retitled AS 2901, *Responding to Engagement Deficiencies After Issuance of the Audit Report*, and related amendments to our attestation standards for broker-dealer engagements;
- (4) supersede our existing standard ET 102 with a new standard, EI 1000, *Integrity and Objectivity*, to better align our ethics requirements with the scope, approach, and terminology of QC 1000; and
- (5) make additional changes to PCAOB standards, rules, and forms.

**Public**

**Comment:** Interested persons may submit written comments to the Board. Comments should be sent by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's website at [pcaobus.org](https://pcaobus.org). Comments also may be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. All comments should refer to PCAOB Rulemaking Docket Matter No. 046 in the subject or reference line and should be received by the Board no later than February 1, 2023.

Board

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**TABLE OF CONTENTS**

**I. EXECUTIVE SUMMARY ..... 5**

**II. BACKGROUND..... 9**

A. OVERVIEW OF EXISTING REQUIREMENTS AND CURRENT PRACTICE .....10

B. OTHER DEVELOPMENTS SINCE THE ADOPTION OF CURRENT PCAOB QC STANDARDS .....28

C. PCAOB OUTREACH AND RESEARCH, INCLUDING THE QC CONCEPT RELEASE .....29

D. ACTIONS BY OTHER STANDARD SETTERS .....31

E. AREAS OF POTENTIAL IMPROVEMENT TO THE QC STANDARDS .....32

**III. PROPOSED QC 1000: BASIC STRUCTURE, TERMINOLOGY, AND SCALABILITY..... 34**

A. BASIC STRUCTURE .....34

B. TERMINOLOGY.....41

C. SCALABILITY .....49

**IV. PROPOSED QC 1000: A FIRM’S SYSTEM OF QUALITY CONTROL..... 56**

A. INTRODUCTION .....56

B. THE FIRM’S QC SYSTEM .....58

C. ROLES AND RESPONSIBILITIES .....67

D. THE FIRM’S RISK ASSESSMENT PROCESS .....76

E. GOVERNANCE AND LEADERSHIP .....91

F. ETHICS AND INDEPENDENCE .....101

G. ACCEPTANCE AND CONTINUANCE OF CLIENT RELATIONSHIPS AND SPECIFIC ENGAGEMENTS .....119

H. ENGAGEMENT PERFORMANCE .....125

I. RESOURCES.....132

J. INFORMATION AND COMMUNICATION .....147

K. MONITORING AND REMEDIATION PROCESS .....157

L. EVALUATING AND REPORTING ON THE QC SYSTEM .....199

M. DOCUMENTATION .....219

**V. ADDITIONAL PROPOSED AMENDMENTS ..... 228**

A. PROPOSED AMENDMENTS TO AS 2901, *CONSIDERATION OF OMITTED PROCEDURES AFTER THE REPORT DATE*, AND RELATED PROPOSED AMENDMENTS.....229

B. PROPOSED RESCISSION OF ET SECTION 102; PROPOSED NEW STANDARD EI 1000; PROPOSED AMENDMENTS TO ET SECTION 191 .....235

C. OTHER PROPOSED AMENDMENTS .....240

**VI. ECONOMIC ANALYSIS..... 244**

A. BASELINE .....245

B. NEED .....262

C. ECONOMIC IMPACTS.....268

D. ALTERNATIVES CONSIDERED .....283

**VII. SPECIAL CONSIDERATIONS FOR EMERGING GROWTH COMPANIES ..... 287**

**VIII. EFFECTIVE DATE ..... 290**

**IX. LIST OF QUESTIONS..... 291**

**X. OPPORTUNITY FOR PUBLIC COMMENT ..... 298**

**APPENDIX 1: PROPOSED QUALITY CONTROL STANDARD (QC 1000)**

**APPENDIX 2: PROPOSED REPORTING RULE AND FORM QC**

**APPENDIX 3: PROPOSED AMENDMENTS TO AS 2901**

**APPENDIX 4: RESCISSION OF ET SECTION 102; PROPOSED EI 1000; AMENDMENTS TO ET SECTION 191**

**APPENDIX 5: OTHER PROPOSED AMENDMENTS**

## I. EXECUTIVE SUMMARY

We are proposing a new PCAOB quality control (“QC”) standard that we believe would lead registered public accounting firms (“firms”) to significantly improve their QC systems. Effective QC systems are crucial for supporting the consistent performance of high-quality audits and other engagements under PCAOB standards. We have developed an integrated, risk-based standard, QC 1000, *A Firm’s System of Quality Control*, that we believe could be applied by firms of varying size and complexity. In connection with the proposal of QC 1000, we are also proposing a number of other changes to our standards and rules.

### **Improving Our QC Standards**

Inspections and enforcement activities, as well as the research and outreach we have conducted, suggest that there is significant room for improvement in QC systems’ ability to provide reasonable assurance that firms are performing their work in accordance with our standards and other applicable requirements.

Our current QC standards were developed decades ago and issued by the American Institute of CPAs (“AICPA”) before the PCAOB was established. The auditing environment has changed significantly since that time, including evolving and greater use of technology, and increasing auditor use of outside resources, including other firms and providers of support services. Firms themselves have also changed significantly, as has the role of firm networks. Historically, our advisory groups have indicated general support for strengthening the QC standards, including support for implementing a risk-based approach and for enhancing requirements for firm governance and leadership. And advances in internal control, quality management, and enterprise risk management suggest that factors such as active involvement of leadership, focus on risk, clearly defined objectives, objective-oriented processes, monitoring, and remediation of identified issues can contribute to more effective QC.

Taking these considerations into account, we preliminarily believe our QC standards could be improved, thereby leading firms to improve their QC systems and ultimately better comply with applicable requirements, by:

- Expressly requiring a risk-based approach to QC, including well-defined quality objectives and a systematic effort to identify and proactively manage risks to the firm’s achieving those objectives;
- Emphasizing firm governance, the “tone at the top,” and individual accountability;
- Providing more direction regarding monitoring activities and remediation of identified deficiencies to encourage an ongoing feedback loop that drives continuous improvement;

- Addressing changes in the audit practice environment, including the increasing participation of other firms and other outside resources, the role of firm networks, the evolving use of technology and other resources, and the increasing importance of internal and external firm communications;
- Providing for a rigorous annual evaluation of a firm's QC system;
- Introducing annual QC reporting to the PCAOB to underscore the importance of the annual evaluation of the QC system and support PCAOB oversight; and
- Requiring enhanced communication to the audit committee.

Our preliminary view is that the basic objectives of the QC system should be the same across all firms, but that there should be flexibility in the requirements of the QC standard and the extent to which they apply depending on the nature and circumstances of the firm.

The specific policies and procedures necessary to achieve the objectives of the QC system could vary significantly. This variance could depend on firm size, engagement types, and other factors. We believe that our QC standard should be sufficiently principles-based and scalable that firms could pursue an approach to QC that is appropriate in light of their specific circumstances.

We are also considering whether there may be specific areas, such as firm governance, where larger firms should be subject to enhanced requirements, given such firms' greater complexity and the relatively greater public interest implicated by the fact that they audit companies that make up a substantial majority of U.S. public market capitalization. In general, however, our preliminary view is that firms that perform engagements under our standards should be subject to the same QC requirements regardless of size.

We are aware that a significant number of registered firms do not perform engagements under PCAOB standards every year. Our preliminary view is that the risk to investor protection is minimal if the firm is not performing or playing a substantial role in such engagements, and that it would be appropriate to provide for more limited QC obligations in those circumstances.

### **Proposed QC 1000**

The proposed standard takes an approach that substantially reflects the discussion in our December 2019 concept release, which most commenters supported.

Proposed QC 1000 provides a framework for a QC system that is grounded in proactively identifying and managing risks to quality, with a feedback loop from ongoing monitoring and remediation that should drive continuous improvement, an explicit focus on firm governance

and leadership and individual accountability, and specific direction in a number of areas that our current standards do not address directly. Proposed QC 1000 has eight basic components, consisting of:

**Two process components**

- The firm’s risk assessment process
- The monitoring and remediation process

**Six components that address aspects of the firm’s organization and operations**

- Governance and leadership
- Ethics and independence
- Acceptance and continuance of client relationships and specific engagements
- Engagement performance
- Resources
- Information and communication

The proposed standard also includes requirements regarding individual roles and responsibilities in the QC system, a requirement to evaluate the effectiveness of the QC system annually and report on the results of that evaluation to the PCAOB and to the audit committee (or equivalent) of each issuer and broker-dealer audit client, and documentation requirements. The proposed text of QC 1000 is attached as Appendix 1 and the proposed QC reporting rule and form are attached as Appendix 2.

Under the proposal, all registered firms would be required to design a QC system that meets the requirements of QC 1000. Firms would be required to implement and operate the QC system in compliance with QC 1000 when they perform an engagement under PCAOB standards, play a substantial role in the preparation or furnishing of an audit report (as defined in our rules), or have current responsibilities under applicable professional and legal requirements regarding any such engagement.

**Comparison to International and AICPA QC Standards**

The development of our proposal has been informed by the approach to QC standards taken by other audit standard setters, as reflected in International Standard on Quality Management 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* (“ISQM 1”), adopted by the

International Auditing and Assurance Standards Board (“IAASB”), and the Statement on Quality Management Standards (SQMS) No. 1, *A Firm's System of Quality Management* (“SQMS 1”), adopted by the AICPA. The structure we are proposing for QC 1000 is similar to the structure of ISQM 1 and SQMS 1.

However, we have carefully analyzed every aspect of the approach taken by these other standard setters and have considered where to align and where to include alternative or incremental provisions that we believe would better protect and serve investors and further the public interest. As a result, our proposal does not completely align with these other standards and includes a number of provisions that we believe are appropriate to address our environment, the needs and priorities of our stakeholders, and our statutory mandate of protecting investors and the public interest, including:

- Requirements regarding involvement of independent individuals in firm governance for the largest firms;
- An ethics and independence component aligned with SEC and PCAOB requirements;
- Specified requirements regarding firm technological resources;
- More specific requirements for the monitoring and remediation process;
- Guidelines regarding a firm’s voluntary publication of information, firm statistics, or firm and engagement performance metrics; and
- A more structured approach to the firm’s annual evaluation of its QC system coupled with a reporting requirement on new Form QC.

We believe that building on a common basic structure with other audit standard setters, with appropriate differences, would enable our regulatory objectives to be accomplished more effectively, as well as more efficiently and at a lower cost to the firms we regulate, than if we developed an entirely different structure of our own. In designing, implementing, and operating their QC systems, firms that are subject to both PCAOB standards and IAASB or AICPA QC standards—which we believe is a very substantial majority of the firms that perform engagements under our standards—could leverage the investments they make to comply with the requirements of the IAASB and/or the AICPA and avoid the additional costs that would be associated with designing, implementing, and operating fundamentally different, and potentially conflicting, approaches to QC.

### **Other Proposed Changes**

In connection with the proposal of QC 1000, we are also proposing other changes to our standards, rules, and forms. These include, among other changes, expanding the auditor’s

responsibility to respond to deficiencies on completed engagements under an amended and retitled AS 2901, *Responding to Engagement Deficiencies After Issuance of the Auditor's Report*, and related amendments to AT No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, and AT No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*; and replacing our existing standard ET 102 with a new standard, EI 1000, *Integrity and Objectivity*, to better align our ethics requirements with the scope, approach, and terminology of QC 1000. The proposed amendments to AS 2901, the proposed amendments related to EI 1000, and the other proposed changes are attached as Appendices 3, 4, and 5, respectively.

### **Effective Date**

We are considering an effective date of December 15 of the year after approval by the SEC, with the first evaluation of the QC system to be made as of the following November 30. We also believe that firms should be permitted to elect to comply with the requirements of QC 1000, except reporting to the PCAOB on the annual evaluation of the QC system, before the effective date, at any point after SEC approval of the final standard.

### **Comments on the Proposed Rule and the Other Proposed Amendments**

In this proposing release, we are seeking comment on all aspects of our proposed new QC standard, QC 1000, as well as the other proposed amendments to PCAOB standards, rules, and forms described in this release. We encourage you to read the entire proposing release, which includes a discussion of the proposed provisions, key differences between the proposed standard and both our current QC standards and the QC standards of other standard setters, and an economic analysis.

Throughout this release, we have included specific questions soliciting your feedback on particular aspects of our proposal. You are encouraged to comment on any or all topics, respond to any or all questions, provide feedback in areas not covered by specific questions, and provide any evidence (e.g., data or practical experiences) that informs your views.

## **II. BACKGROUND**

This section presents background information on this rulemaking, including an overview of our existing QC requirements and current practice, a review of other developments since our current QC requirements were adopted, a summary of relevant actions taken by other standard setters, a discussion of our research and outreach efforts related to QC and our December 2019

concept release,<sup>1</sup> and a summary of the key areas we have identified for improvement of the QC standards.

## A. Overview of Existing Requirements and Current Practice

### 1. Requirements of the Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002, as amended (“Sarbanes-Oxley”), requires the Board to establish certain professional standards, including quality control standards, to be used by registered public accounting firms in the preparation and issuance of audit reports for issuers, brokers, and dealers.<sup>2</sup> Furthermore, Sarbanes-Oxley requires the PCAOB’s QC standards to address:

- Monitoring of professional ethics and independence from issuers, brokers, and dealers on behalf of which the firm issues audit reports;
- Consultation within the firm on accounting and auditing questions;
- Supervision of audit work;
- Hiring, professional development, and advancement of personnel;
- Acceptance and continuation of engagements;
- Internal inspection; and
- Such other requirements as the Board may prescribe.<sup>3</sup>

### 2. Current PCAOB QC standards

Under current PCAOB standards, a QC system is a process to provide a firm with reasonable assurance that its personnel comply with applicable professional standards and the

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<sup>1</sup> See *Concept Release, Potential Approach to Revisions to PCAOB Quality Control Standards*, PCAOB Release No. 2019-003 (Dec. 17, 2019) (“Concept Release”), available on the Board’s website in Docket 046.

<sup>2</sup> See Sections 101(c)(2) and 103(a)(1) of Sarbanes-Oxley, 15 U.S.C. §§ 7211(c)(2), 7213(a)(1). This release uses the terms “issuer,” “broker,” and “dealer” as defined in Sarbanes-Oxley. See Section 2(a)(7) of Sarbanes-Oxley, 15 U.S.C. § 7201(7) (defining “issuer”); Sections 110(3) and (4) of Sarbanes-Oxley, 15 U.S.C. §§ 7220(3), (4) (defining “broker” and “dealer”); see also PCAOB Rules 1001(b)(iii), (d)(iii), (i)(iii) (defining “broker,” “dealer,” and “issuer,” respectively). Entities that are brokers or dealers or both are sometimes referred to herein as “broker-dealers.”

<sup>3</sup> See Section 103(a)(2)(B) of Sarbanes-Oxley, 15 U.S.C. § 7213(a)(2)(B).

firm's standards of quality.<sup>4</sup> The QC system encompasses the firm's organizational structure and the policies adopted and procedures established to provide that reasonable assurance.<sup>5</sup>

Current PCAOB QC standards were adopted on an interim, transitional basis in 2003 from QC standards originally developed and issued by the AICPA.<sup>6</sup> They include three general QC standards that apply to all firms.<sup>7</sup> Beyond that, they also include certain requirements of membership in the AICPA's former SEC Practice Section ("SECPS"), which apply only to firms that were SECPS members immediately prior to the adoption of our interim QC standards. Below, we provide an overview of the general QC standards and the SECPS member requirements.

**a. General QC standards**

**i. QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice***

QC 20 provides that a firm should have a system of quality control that provides the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality.<sup>8</sup> The firm's quality control policies and procedures should address the following elements:

- Independence, integrity, and objectivity;
- Personnel management;
- Acceptance and continuance of clients and engagements;
- Engagement performance; and

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<sup>4</sup> See paragraph .03 of QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

<sup>5</sup> See QC 20.04.

<sup>6</sup> See PCAOB Rule 3400T, *Interim Quality Control Standards*; see also *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (Apr. 18, 2003).

<sup>7</sup> Under PCAOB Rule 3400T(a), all firms are required to comply with QC standards as described in "the AICPA's Auditing Standards Board's Statements on Quality Control Standards, as in existence on April 16, 2003 (AICPA Professional Standards, QC §§ 20-40 (AICPA 2002)), to the extent not superseded or amended by the Board." PCAOB Rule 3400T(a).

<sup>8</sup> See QC 20.03.

- Monitoring.<sup>9</sup>

These elements of quality control are interrelated.<sup>10</sup> Policies and procedures should be established to provide the firm with reasonable assurance with respect to each of these elements of QC. An appropriate individual or individuals in the firm should be assigned responsibility for the design and maintenance of the various quality control policies and procedures.<sup>11</sup> These policies and procedures should be communicated in a manner that provides reasonable assurance that personnel will understand and comply.<sup>12</sup> Additionally, documentation should be prepared to demonstrate compliance with the firm's policies and procedures for the elements of quality control.<sup>13</sup>

#### ii. *QC 30, Monitoring a CPA Firm's Accounting and Auditing Practice*

QC 30 addresses how a firm should implement the monitoring element of quality control discussed in QC 20. Monitoring involves an ongoing consideration and evaluation of the following:

- The relevance and adequacy of the firm's policies and procedures;
- The appropriateness of the firm's guidance materials and any practice aids;
- The effectiveness of professional development activities; and
- Compliance with the firm's policies and procedures.<sup>14</sup>

Under QC 30, monitoring procedures should enable the firm to obtain reasonable assurance that its system of quality control is effective.<sup>15</sup> A firm's monitoring procedures may include:

- Inspection procedures;
- Preissuance or postissuance review of selected engagements;

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<sup>9</sup> See QC 20.07.

<sup>10</sup> See QC 20.08.

<sup>11</sup> See QC 20.22.

<sup>12</sup> See QC 20.23.

<sup>13</sup> See QC 20.25.

<sup>14</sup> See QC 30.02.

<sup>15</sup> See QC 30.03.

- Analysis and assessment of:
  - New professional pronouncements;
  - Results of independence confirmations;
  - Continuing professional education (“CPE”) and other professional development activities undertaken by firm personnel;
  - Decisions related to acceptance and continuance of client relationships and engagements; and
  - Interviews of firm personnel;
- Determination of any corrective actions to be taken and improvements to be made in the quality control system;
- Communication to appropriate firm personnel of any weaknesses identified in the quality control system or in the level of understanding or compliance therewith; and
- Follow-up by appropriate firm personnel to ensure that any necessary modifications are made to the quality control policies and procedures on a timely basis.<sup>16</sup>

The nature and extent of monitoring procedures generally depends on the firm’s size and the nature and complexity of the firm’s practice.<sup>17</sup> QC 30 provides that individuals in a small firm may perform monitoring procedures, including postissuance review of engagement working papers, reports, and clients’ financial statements, with respect to their own compliance with the firm’s QC policies and procedures, but only if such individuals are able to critically review their own performance, assess their own strengths and weaknesses, and maintain an attitude of continual improvement.<sup>18</sup>

*iii. QC 40, The Personnel Management Element of a Firm’s System of Quality Control — Competencies Required by a Practitioner-in-Charge of an Attest Engagement*

QC 40 addresses the personnel management element of the quality control system. Personnel management includes hiring, assigning personnel to engagements, professional

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<sup>16</sup> See QC 30.03.

<sup>17</sup> See, e.g., QC 30.05, .10, .11.

<sup>18</sup> See QC 30.09, .10.

development, and advancement activities. Policies and procedures should be established to provide the firm with reasonable assurance that:

- a. Those hired possess the appropriate characteristics to enable them to perform competently.
- b. Work is assigned to personnel having the degree of technical training and proficiency required in the circumstances.
- c. Personnel participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned, and satisfy applicable professional education requirements of the AICPA, and regulatory agencies.
- d. Personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.<sup>19</sup>

A firm's policies and procedures related to personnel management should be designed to provide a firm with reasonable assurance that practitioners-in-charge of engagements (i.e., engagement partners) possess the kinds of competencies that are appropriate given the circumstances of the client engagement.<sup>20</sup> Competencies are the knowledge, skills, and abilities that enable an engagement partner to be qualified to perform an engagement.<sup>21</sup> Competencies may be gained in various ways, including through relevant industry, governmental, and academic positions.<sup>22</sup> A firm's policies and procedures should ordinarily address the following competencies for an engagement partner:

- Understanding of the role of a system of quality control and a code of professional conduct;
- Understanding of the service to be performed;
- Technical proficiency;
- Familiarity with the industry;
- Professional judgment; and

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<sup>19</sup> See QC 40.02.

<sup>20</sup> See QC 40.03.

<sup>21</sup> See QC 40.04.

<sup>22</sup> See QC 40.05.

- Understanding the organization’s information technology systems.<sup>23</sup>

Under QC 40, these competencies are interrelated.<sup>24</sup> When establishing policies and procedures related to competencies needed by an engagement partner, a firm may need to consider the requirements of policies and procedures established for other elements of quality control.<sup>25</sup>

#### **b. SECPS member requirements**

The SECPS was a division of the AICPA for U.S. firms that audited public companies, which established incremental quality control requirements for its members. The SECPS requirements originally applied to all U.S. firms that audited public companies under AICPA standards. The SECPS ceased to exist following establishment of the PCAOB.

Under PCAOB rules, certain SECPS requirements still apply to firms that were members of the SECPS as of April 16, 2003.<sup>26</sup> Based on current registration data, the SECPS member requirements apply to 216 (approximately 13% of) PCAOB-registered firms, including 11 of the 14 annually inspected firms in 2022.

##### **i. [Section 1000.08\(d\) – Continuing Professional Education of Audit Firm Personnel](#)**

Section 1000.08(d) requires SECPS member firms to ensure that all professionals residing in the United States, both CPAs and non-CPAs, participate in at least 20 hours of qualifying CPE every year and at least 120 hours every three years.<sup>27</sup> Professionals who devote at least 25% of their time to performing audit, review, or other attest engagements, or who

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<sup>23</sup> See QC 40.08.

<sup>24</sup> See QC 40.09.

<sup>25</sup> See QC 40.10.

<sup>26</sup> PCAOB Rule 3400T(b) requires certain firms to comply with QC standards as described in “the AICPA SEC Practice Section’s Requirements of Membership (d), (l), (m), (n)(1) and (o), as in existence on April 16, 2003 (AICPA SEC Practice Section Manual § 1000.08(d), (j), (m), (n)(1) and (o)), to the extent not superseded or amended by the Board.” PCAOB Rule 3400T(b). Rule 3400T provides that those requirements “only apply to those registered public accounting firms that were members of the AICPA SEC Practice Section on April 16, 2003.” Note to PCAOB Rule 3400T. One of the SECPS member requirements, concerning concurring partner review, was superseded in 2009 by the PCAOB’s adoption of AS 1220, *Engagement Quality Review*.

<sup>27</sup> See SECPS § 1000.08(d).

have responsibility for supervision or review of such engagements, must obtain at least 40% of their CPE hours in subjects related to accounting and auditing.<sup>28</sup>

Additional information on Section 1000.08(d)'s CPE requirements appears in SECPS Section 8000, *Continuing Professional Education Requirements Effective for Educational Years Beginning After May 31, 2002*.<sup>29</sup> That information is summarized into three categories: (1) record-keeping for each professional to ensure that each professional adheres to all CPE requirements; (2) adherence to standards for CPE program sponsors for each program sponsored by the member firm; and (3) compliance with additional CPE requirements of the SECPS.<sup>30</sup> Appendix A to Section 8000 includes the AICPA policies related to CPE.

ii. [Section 1000.08\(l\) – Communication by Written Statement to all Professional Personnel of Firm Policies and Procedures on the Recommendation and Approval of Accounting Principles, Present and Potential Client Relationships, and the Types of Services Provided](#)

Section 1000.08(l) requires SECPS member firms to communicate, through a written statement, to all professional firm personnel the broad principles that influence the firm's quality control and operating policies and procedures.<sup>31</sup> Periodic communication also must inform professional firm personnel that compliance with those principles is mandatory.<sup>32</sup>

iii. [Section 1000.08\(m\) – Notification of the Commission of Resignations and Dismissals from Audit Engagements for Commission Registrants](#)

Section 1000.08(m) requires that, if an SECPS member firm has resigned, declined to stand for re-election, or been dismissed as the auditor of an SEC registrant and the registrant has not reported the change in auditors to the SEC in a timely filed Form 8-K, the member firm is to report that the client-auditor relationship has ceased directly, in writing, to the former SEC client and the SEC within five business days.<sup>33</sup>

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<sup>28</sup> See SECPS § 1000.08(d).

<sup>29</sup> See SECPS § 1000.08(d) (referring, in a footnote, to Section 8000).

<sup>30</sup> See SECPS § 8000.

<sup>31</sup> See SECPS § 1000.08(l). Section 1000.08(l) includes a cross-reference to Appendix H SECPS Section 1000.42, *Illustrative Statement of Firm Philosophy*, which provides an illustration of such a statement.

<sup>32</sup> See SECPS § 1000.08(l).

<sup>33</sup> See SECPS § 1000.08(m). Section 1000.08(m) cross-references Appendix D SECPS Section 1000.38, *Revised Definition of an SEC Client*, which provides the definition of an SEC client, as well as

iv. [Section 1000.08\(n\) – Audit Firm Obligations with Respect to the Policies and Procedures of Correspondent Firms and of Other Members of International Firms or International Associations of Firms](#)

Section 1000.08(n) requires SECPS member firms that are members of, correspondents with, or similarly associated with international firms or international associations of firms to seek adoption of policies and procedures that are consistent with the objectives in Appendix K (SECPS Section 1000.45), *SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants*.<sup>34</sup>

Appendix K was adopted with the intention of enhancing the quality of SEC filings by issuers whose financial statements are audited by foreign associated firms of SECPS member firms.<sup>35</sup> It requires SECPS member firms to seek adoption by their international organizations or individual foreign associated firms of certain policies and procedures, including:

- Procedures to be performed on certain SEC filings by a filing reviewer who is knowledgeable in applicable accounting and auditing standards, independence requirements, and SEC rules and regulations;
- Inspection procedures for a sample of audit engagements performed by foreign associated firms for issuer clients, to be performed by inspection reviewers who are knowledgeable in the same areas as filing reviewers; and
- Policies and procedures under which disagreements between the filing or inspection reviewer and the audit partner-in-charge should be resolved in accordance with the policy of the international organization or the filing or inspection reviewer's firm.<sup>36</sup>

v. [Section 1000.08\(o\) – Policies and Procedures to Comply with Independence Requirements](#)

Section 1000.08(o) requires SECPS member firms to have policies and procedures in place to comply with applicable independence requirements.<sup>37</sup>

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Appendix I SECPS Section 1000.43, *Standard Form of Letter Confirming the Cessation of the Client-Auditor Relationship*, which provides a standard form of such report.

<sup>34</sup> See SECPS § 1000.08(n).

<sup>35</sup> See SECPS § 1000.45.01.

<sup>36</sup> See SECPS § 1000.45.01.

<sup>37</sup> See SECPS § 1000.08(o).

Section 1000.08(o) cross-references Appendix L, SECPS Section 1000.46, *Independence Quality Controls*, which requires firms to establish written policies<sup>38</sup> covering relationships with “restricted entities,” for example, relationships between the restricted entity and the member firm, its benefit plans, and its professionals.<sup>39</sup> These relationships include investments, loans, brokerage accounts, business relationships, employment relationships, proscribed services, and fee arrangements.<sup>40</sup> Firms should maintain a database that includes all restricted entities (“restricted entity list”) and make the restricted entity list available to the firm’s professionals and to foreign associated firms.<sup>41</sup>

A senior-level partner should be designated to oversee the independence policies and maintain and communicate the restricted entity list.<sup>42</sup> The policies and procedures also should require:

- Reviewing the restricted entity list prior to obtaining any security;
- Obtaining independence certifications from the firm’s professionals;
- Reporting violations of policies;
- Establishing a monitoring system; and
- Developing policies for potential sanctions for violations of the firm’s policies and procedures or professional independence requirements.<sup>43</sup>

The policies and procedures should be made available to all professionals and a training program should be established to provide reasonable assurance that professionals understand the policies.<sup>44</sup>

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<sup>38</sup> PCAOB rules do not mandate that writings be paper-based. *See, e.g.*, AS 1215.04 (audit documentation may be in the form of paper, electronic files, or other media).

<sup>39</sup> *See* SECPS § 1000.46 (requirement 1).

<sup>40</sup> *See* SECPS § 1000.46 (requirement 1).

<sup>41</sup> *See* SECPS § 1000.46 (requirements 4, 5, and 6).

<sup>42</sup> *See* SECPS § 1000.46 (requirement 5).

<sup>43</sup> *See* SECPS § 1000.46 (requirement 7).

<sup>44</sup> *See* SECPS § 1000.46 (requirement 3).

### 3. Observations from oversight activities

In the course of conducting inspections of registered public accounting firms<sup>45</sup> and investigating potential violations of our standards and other related laws and rules governing audits of public companies and audits and attestation engagements of broker-dealers, we may identify deficiencies in firms' execution of engagements and in firms' QC systems. Our oversight activities also help us to identify good practices, both for engagements and for QC systems. We also consider information derived from the SEC's enforcement program.

Over time, firms have implemented a number of changes to their QC systems to remediate deficiencies identified through our inspections program.<sup>46</sup> Examples of changes firms have made in response to the Board's inspections include:<sup>47</sup>

- *Independence* - Creating automated links between the firm's tools for tracking subcontractors and evaluating and tracking business relationships to ensure that independence evaluations are complete and timely;
- *Engagement Performance* - Implementing new policies and procedures for engagement teams to focus on obtaining a thorough understanding of how issuers initiate, record, process, and report significant classes of transactions and how that information is recorded in the financial statements;
- *Resources* - Creating a committee to evaluate partner performance in relation to audit quality and establishing an accountability framework with penalties for negative audit quality events;
- *Monitoring and Remediation* - Adding new leadership positions to the internal inspection program, developing new analysis and reporting of internal inspection findings, and disseminating such findings more broadly; and

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<sup>45</sup> The information on inspections and remediation efforts is limited to those firms that are subject to inspection under Sarbanes-Oxley, that is, firms that provide one or more audit reports for an issuer, broker, or dealer. See Sections 104(a)-(b) of Sarbanes-Oxley, 15 U.S.C. §§ 7214(a)-(b).

<sup>46</sup> Additional information about the PCAOB remediation process is available on the PCAOB website at [https://pcaobus.org/oversight/inspections/remediation/remediation\\_process](https://pcaobus.org/oversight/inspections/remediation/remediation_process).

<sup>47</sup> Examples are drawn from firms' Rule 4009 submissions. A Rule 4009 submission is a confidential submission prepared by a firm, pursuant to PCAOB Rule 4009, *Firm Response to Quality Control Defects*, concerning the ways in which a firm has addressed a QC criticism. For additional background, see *The Process of Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports*, PCAOB Release No. 104-2006-077 (Mar. 21, 2006).

- *Monitoring and Remediation* - Adding in-process review and coaching programs to assist engagement teams in certain challenging areas, including internal control over financial reporting (“ICFR”) and accounting estimates.

Observations from our oversight activities have shown that improvements in quality controls can enhance the quality of engagements.<sup>48</sup> However, our inspections continue to identify deficiencies for some firms, suggesting that not all firms have made meaningful improvements in these areas. The following summarizes recent observations from our inspections<sup>49</sup> and investigations of QC systems, including deficiencies and violations—instances of noncompliance with PCAOB requirements—and good practices that we believe support and strengthen QC systems. We have taken these observations into account in developing our proposal.

#### **a. QC deficiencies and violations observed from oversight activities**

Our observations have generally revealed that while some firms have made improvements to their QC systems, the progress has been uneven. Even taking that progress into account, in roughly a third of the issuer audits we inspected from 2018 to 2020, the auditor’s opinion was not adequately supported.<sup>50</sup> This suggests that there is significant room for improvement in QC systems’ ability to provide reasonable assurance that firm engagements are performed in accordance with applicable professional standards and regulatory requirements.

As described below, our observations all too frequently indicate that firms’ QC systems did not appear to provide reasonable assurance that firm personnel will comply with applicable

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<sup>48</sup> See, e.g., 2018 Inspection Observations Preview at 1-4.

<sup>49</sup> PCAOB inspections are designed to assess a firm’s compliance with PCAOB standards and rules and other applicable regulatory and professional requirements with respect to the firm’s QC system and in the portions of engagements selected for review. An inspection does not involve a review of all aspects of a firm’s QC system. An inspection also does not necessarily involve a review of all of a firm’s engagements, nor is it designed to identify every deficiency in the reviewed engagements.

The inspection data are derived from PCAOB inspection reports. Part II of our inspection reports includes criticisms of, and potential defects in, a firm’s QC system, to the extent any are identified. We include, in Part II of our inspection reports, deficiencies observed in inspections of individual engagements when the results indicate that the firm’s QC system does not provide reasonable assurance that firm personnel will comply with applicable professional standards and regulatory requirements. In evaluating whether engagement observations are indicative of QC deficiencies, PCAOB staff consider the nature, significance, and frequency of deficiencies; related firm methodology, guidance, and practices; and possible root causes.

<sup>50</sup> See Figure 1, Section VI.A.1, and accompanying text for an analysis of 2018-2020 inspections data.

professional standards in, among others, the areas of: (1) engagement performance; (2) independence, integrity, and objectivity; (3) personnel management; (4) monitoring; and (5) engagement quality reviews. Below, we provide examples of our observations in these areas.

#### i. Engagement performance

A properly functioning QC system should provide the firm with reasonable assurance that the work performed by engagement personnel meets applicable professional standards, regulatory requirements, and the firm's standards of quality.<sup>51</sup> A QC system cannot provide reasonable assurance if, for example, there are severe, frequent, or widespread deficiencies, or recurring instances of similar types of deficiencies at the engagement level. We have observed deficiencies and violations in a range of areas of engagement performance, including, for example:

- Failure to identify and test controls that address risks of material misstatement or sufficiently evaluate review controls;
- Insufficient evaluation of significant assumptions or data used in developing an estimate;
- Unwarranted reliance on data or reports used in testing an issuer's financial reporting controls or in substantive testing;<sup>52</sup>
- Engagement partners' failure to adequately supervise the engagement with due professional care, which contributed to not identifying these or other deficiencies;<sup>53</sup>

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<sup>51</sup> See QC 20.17.

<sup>52</sup> See, e.g., *In the Matter of PKF O'Connor Davies, LLP*, PCAOB Release No. 105-2022-001 (Jan. 25, 2022).

<sup>53</sup> See, e.g., *In the Matter of Mancera, S.C., Alejandro Valdez Mendoza, C.P., and Angel Radames Corral Nieblas, C.P.*, SEC Accounting and Auditing Enforcement Release ("AAER") No. 4198 (Dec. 17, 2020); *In the Matter of Whitley Penn LLP, Susan Lunn Powell, CPA, Jeffry Shannon Lawlis, CPA, and John Griffin Babb, CPA*, PCAOB Release No. 105-2020-002 (Mar. 24, 2020); *In the Matter of David M. Burns, CPA*, PCAOB Release No. 105-2017-055 (Dec. 19, 2017); *In the Matter of BDO Auditores, S.L.P., Santiago Sañé Figueras, and José Ignacio Algás Fernández*, PCAOB Release No. 105-2017-039 (Sept. 26, 2017); *In the Matter of KPMG LLP and John Riordan, CPA*, SEC AAER No. 3888 (Aug. 15, 2017).

- Failure to implement and maintain adequate policies and procedures to provide reasonable assurance that work is performed and documented;<sup>54</sup> and
- Failure to ensure audits are performed under PCAOB standards and not another framework.<sup>55</sup>

## ii. Independence, integrity, and objectivity

A firm's QC system should also provide the firm with reasonable assurance that personnel maintain independence—in fact and in appearance—in all required circumstances.<sup>56</sup> Observations relating to auditor independence have been recurring over the last several years.<sup>57</sup> Examples of these observations frequently have included:

- Violations of independence, including financial relationship and partner rotation requirements of Rule 2-01 of SEC Regulation S-X;<sup>58</sup>

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<sup>54</sup> See, e.g., *In the Matter of HLB Mann Judd, Darryl Swindells, and Aidan Smith*, PCAOB Release No. 105-2020-008 (June 29, 2020); *In the Matter of Castillo Miranda y Compañía, S.C., Ignacio García Pareras, Juan Martín Gudiño Casillas, Luis Raúl Michel Domínguez, Juan Francisco Olvera Díaz, Carlos Rivas Ramos, and Bernardo Soto Peñafiel*, PCAOB Release No. 105-2019-028 (Oct. 31, 2019); *In the Matter of Deloitte Anjin LLC*, PCAOB Release No. 105-2019-025 (Oct. 31, 2019); *In the Matter of Deloitte Touche Tohmatsu Auditores Independientes*, PCAOB Release No 105-2016-031 (Dec. 5, 2016).

<sup>55</sup> See, e.g., *In the Matter of Dale Matheson Carr-Hilton LaBonte LLP*, PCAOB Release No. 105-2021-021 (Dec. 14, 2021); *In the Matter of WDM Chartered Professional Accountants and Mike Kao*, PCAOB Release No. 105-2021-016 (Sept. 30, 2021).

<sup>56</sup> See QC 20.09.

<sup>57</sup> See, e.g., PCAOB, *Staff Inspection Brief: Inspections Outlook for 2019* (Dec. 6, 2018) ("2019 Inspections Outlook"), at 2, available at [https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/inspections/documents/inspections-outlook-for-2019.pdf?sfvrsn=538b8bb7\\_2](https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/inspections/documents/inspections-outlook-for-2019.pdf?sfvrsn=538b8bb7_2); PCAOB, *Spotlight: Staff Update and Preview of 2019 Inspection Observations* (Oct. 8, 2020) ("2019 Inspection Observations Preview"), at 7, available at [https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/inspections/documents/staff-preview-2019-inspection-observations-spotlight.pdf?sfvrsn=57617c98\\_2](https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/inspections/documents/staff-preview-2019-inspection-observations-spotlight.pdf?sfvrsn=57617c98_2); PCAOB, *Spotlight: Staff Update and Preview of 2020 Inspection Observations* (Oct. 2021) ("2020 Inspection Observations Preview"), at 12, available at [https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/documents/staff-preview-2020-inspection-observations-spotlight.pdf?sfvrsn=10819041\\_4](https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/documents/staff-preview-2020-inspection-observations-spotlight.pdf?sfvrsn=10819041_4).

<sup>58</sup> 17 C.F.R. § 210.2-01. See, e.g., *In the Matter of Ernst & Young LLP, James G. Herring, Jr., CPA, James A. Young, CPA, and Curt W. Fochtman, CPA*, SEC AAER No. 4239 (Aug. 2, 2021); *In the Matter of Raich Ende Malter & Co.*, PCAOB Release No. 105-2019-009 (Apr. 9, 2019); *In the Matter of Marcum LLP and Alfonse Gregory Giugliano, CPA*, PCAOB Release No. 105-2019-022 (Sept. 10, 2019); *In the Matter of Marcum Bernstein & Pinchuk LLP*, PCAOB Release No. 105-2019-023 (Sept. 10, 2019).

- Noncompliance by firm personnel in reporting their financial relationships during the independence confirmation process;
- Independence violations related to the firm providing impermissible non-audit services;<sup>59</sup>
- Noncompliance with PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*, and PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*;<sup>60</sup> and
- Improper inclusion of indemnification clauses in engagement letters, which impaired independence based on the general standard of independence prescribed by Rule 2-01(b) of SEC Regulation S-X.

There have also been instances where personnel have improperly shared answers on examinations required to obtain or maintain professional licenses,<sup>61</sup> or otherwise have not acted with integrity by altering work papers<sup>62</sup> or failing to cooperate with the Board.<sup>63</sup>

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<sup>59</sup> See, e.g., *In the Matter of Pricewaterhousecoopers LLP*, SEC AAER No. 4084 (Sept. 23, 2019) and *In the Matter of RSM US LLP (f/k/a McGladrey LLP)*, SEC AAER No. 4066 (Aug. 27, 2019).

<sup>60</sup> See, e.g., *In the Matter of PricewaterhouseCoopers, S.C.*, PCAOB Release No. 105-2019-017 (Aug. 1, 2019); *In the Matter of BDO Magyarország Konyvvizsgalo Kft.*, PCAOB Release No. 105-2017-024 (Apr. 12, 2017).

<sup>61</sup> See, e.g., *In the Matter of Ernst & Young LLP*, SEC AAER No. 4313 (June 28, 2022); *In the Matter of PricewaterhouseCoopers LLP*, PCAOB Release No. 105-2022-002 (Feb. 24, 2022); *In the Matter of KPMG*, PCAOB Release No. 105-2021-008 (Sept. 13, 2021); *In the Matter of KPMG LLP*, SEC AAER No. 4051 (June 17, 2019).

<sup>62</sup> See, e.g., *In the Matter of Castillo Miranda y Compañía, S.C.; Ignacio García Pareras; Juan Martín Gudiño Casillas; Luis Raúl Michel Domínguez; Juan Francisco Olvera Díaz; Carlos Rivas Ramos; and Bernardo Soto Peñafiel*, PCAOB Release No. 105-2019-028 (Oct. 31, 2019); *In the Matter of Deloitte Anjin LLC*, PCAOB Release No. 105-2019-025 (Oct. 31, 2019); *In the Matter of Deloitte Touche Tohmatsu Auditores Independientes*, PCAOB Release No 105-2016-031 (Dec. 5, 2016).

<sup>63</sup> See, e.g., *In the Matter of Castillo Miranda y Compañía, S.C.; Ignacio García Pareras; Juan Martín Gudiño Casillas; Luis Raúl Michel Domínguez; Juan Francisco Olvera Díaz; Carlos Rivas Ramos; and Bernardo Soto Peñafiel*, PCAOB Release No. 105-2019-028 (Oct. 31, 2019); *In the Matter of Deloitte Touche Tohmatsu Auditores Independientes*, PCAOB Release No 105-2016-031 (Dec. 5, 2016).

These recurring deficiencies and violations suggest that some firms and their personnel either do not sufficiently understand applicable independence requirements or do not have appropriate controls in place to prevent violations.<sup>64</sup>

### iii. Personnel management

The quality of a firm's work ultimately depends on the integrity, objectivity, intelligence, competence, experience, and motivation of personnel who perform, supervise, and review the work.<sup>65</sup> A firm's QC system should provide the firm with reasonable assurance that personnel participate in general and industry-specific CPE and other professional development activities that enable them to fulfill responsibilities assigned and satisfy applicable CPE requirements.<sup>66</sup> A firm's QC system also should provide the firm with reasonable assurance that personnel possess the appropriate characteristics to enable them to perform competently and that work is assigned to personnel having the degree of technical training and proficiency required in the circumstances.<sup>67</sup>

We have observed deficiencies related to compliance with the firm's auditing policies and procedures. We have also observed deficiencies and violations where the firm did not assign personnel to engagements who had the training and proficiency required to perform audit work in accordance with PCAOB standards.<sup>68</sup>

### iv. Monitoring

A firm's QC system should provide the firm with reasonable assurance that its policies and procedures are suitably designed and effectively applied.<sup>69</sup> We have observed situations where a firm's internal inspection procedures did not detect significant audit deficiencies or the firm did not make changes to address repeated identified audit deficiencies. These deficiencies

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<sup>64</sup> See 2019 Inspections Outlook at 2.

<sup>65</sup> See QC 20.12.

<sup>66</sup> See QC 20.13c.

<sup>67</sup> See QC 20.13a. and b.

<sup>68</sup> See, e.g., *In the Matter of PKF O'Connor Davies, LLP*, PCAOB Release No. 105-2022-001 (Jan. 25, 2022); *In the Matter of WDM Chartered Professional Accountants and Mike Kao*, PCAOB Release No. 105-2021-016 (Sept. 30, 2021); *In the Matter of Grant Thornton*, PCAOB Release No. 105-2017-054 (Dec. 19, 2017); *In the Matter of BDO Auditores, S.L.P., Santiago Sañé Figueras, and José Ignacio Algás Fernández*, PCAOB Release No. 105-2017-039 (Sept. 26, 2017).

<sup>69</sup> See QC 20.20.

and violations were subsequently identified as part of our inspection or enforcement procedures.<sup>70</sup>

#### v. Engagement quality reviews

We have identified deficiencies and violations in audit areas that require the engagement quality reviewer's ("EQR") evaluation,<sup>71</sup> which suggests the EQR did not perform their evaluation with due professional care.<sup>72</sup> Additionally, for certain broker-dealer audit and attestation engagements, we have observed instances where engagement quality reviews were not performed or sufficiently documented<sup>73</sup> and policies and procedures did not provide

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<sup>70</sup> See, e.g., *In the Matter of BMKR LLP and Joseph Mortimer, CPA*, PCAOB Release No. 105-2022-003 (Feb. 24, 2022); *In the Matter of PKF O'Connor Davies, LLP*, PCAOB Release No. 105-2022-001 (Jan. 25, 2022); *In the Matter of WDM Chartered Professional Accountants and Mike Kao*, PCAOB Release No. 105-2021-016 (Sept. 30, 2021); *In the Matter of Haskell & White LLP*, PCAOB Release No. 105-2021-006 (Aug. 13, 2021); *In the Matter of RBSM LLP*, PCAOB Release No. 105-2021-004 (Aug. 9, 2021); *In the Matter of Castillo Miranda y Compañía, S.C., Ignacio García Pareras, Juan Martín Gudiño Casillas, Luis Raúl Michel Domínguez, Juan Francisco Olvera Díaz, Carlos Rivas Ramos, and Bernardo Soto Peñafiel*, PCAOB Release No. 105-2019-028 (Oct. 31, 2019); *In the Matter of Marcum LLP and Alfonse Gregory Giugliano, CPA*, PCAOB Release No. 105-2019-022 (Sept. 10, 2019); *In the Matter of Marcum Bernstein & Pinchuk LLP*, PCAOB Release No. 105-2019-023 (Sept. 10, 2019); *In the Matter of PricewaterhouseCoopers, S.C.*, PCAOB Release No. 105-2019-017 (Aug. 1, 2019); *In the Matter of Bharat Parikh & Associates Chartered Accountants, Bharatkumar Balmukund Parikh, FCA, and Anuj Bharatkumar Parikh*, PCAOB Release No. 105-2019-003 (Mar. 19, 2019); *In the Matter of Grant Thornton*, PCAOB Release No. 105-2017-054 (Dec. 19, 2017).

<sup>71</sup> See, e.g., PCAOB, *Staff Inspection Brief: Staff Preview of 2018 Inspections Observations* (May 6, 2019) ("2018 Inspection Observations Preview"), at 4, available at [https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/inspections/documents/staff-preview-2018-inspection-observations.pdf?sfvrsn=b5f8cb09\\_0](https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/inspections/documents/staff-preview-2018-inspection-observations.pdf?sfvrsn=b5f8cb09_0); 2020 Inspection Observations Preview at 12.

<sup>72</sup> See, e.g., *In the Matter of Donald R. Burke, CPA*, PCAOB Release No. 105-2021-012 (Sept. 29, 2021); *In the Matter of RBSM LLP*, PCAOB Release No. 105-2021-004 (Aug. 9, 2021); *In the Matter of Cheryl L. Gore, CPA and Stanley R. Langston, CPA*, PCAOB Release No. 105-2021-020 (Dec. 14, 2021); *In the Matter of Whitley Penn LLP, Susan Lunn Powell, CPA, Jeffry Shannon Lawlis, CPA, and John Griffin Babb, CPA*, PCAOB Release No. 105-2020-002; *In the Matter of Helen R. Liao, CPA*, PCAOB Release No. 105-2020-014 (Sept. 24, 2020); *In the Matter of Crowe Horwath LLP, Joseph C. Macina, CPA, and Kevin V. Wydra, CPA*, SEC AAER No. 4007 (Dec. 21, 2018); *In the Matter of BDO Auditores, S.L.P., Santiago Sañé Figueras, and José Ignacio Algás Fernández*, PCAOB Release No. 105-2017-039 (Sept. 26, 2017).

<sup>73</sup> See, e.g., *In the Matter of Citrin Cooperman & Company, LLP, Joseph Puglisi, CPA, Mark Schniebold, CPA, and John Cavallone, CPA*, PCAOB Release No. 105-2022-007 (May 11, 2022).

reasonable assurance that engagement quality reviews were performed with due professional care.<sup>74</sup>

## **b. Good practices observed from inspections**

The following observations regarding good QC practices are based on inspections in recent years.<sup>75</sup> A good QC practice could be a procedure, technique, or methodology that is appropriately comprehensive and suitably designed in relation to a firm's size and the nature and complexity of the firm's practice. We have taken these observations into account in our consideration of proposed QC 1000, while recognizing that the nature, extent, and formality of the design, implementation, and operation of QC systems can vary across firms.

### **i. Well-defined QC system**

A well-defined QC system includes all key elements of quality control and is supported by documentation that helps to promote firm personnel's understanding and consistent application of the firm's QC system. Helpful characteristics that we have observed in some firms' QC systems include:

- Narratives and process flows that articulate how and where quality objectives fit within the QC processes and define risks posed to those quality objectives, including considering what could go wrong along the way;<sup>76</sup> and
- Developing risk and control matrices that include well-defined controls.

### **ii. Accountability for audit quality**

Leadership involvement in and commitment to a firm's QC system sets the tone at the top and drives clear expectations regarding the importance of audit quality. We observed positive behaviors where firms have placed an emphasis on the importance of audit quality through extending accountability beyond engagement partners to other key leaders at the firm, such as audit quality leaders, technical experts, and office leaders, through performance management processes.<sup>77</sup>

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<sup>74</sup> See *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers*, PCAOB Release No. 2022-004 (Aug. 19, 2022) ("2021 Broker-Dealer Inspection Report"), at 31.

<sup>75</sup> See, e.g., 2018 Inspection Observations Preview, 2019 Inspection Observations Preview, and 2020 Inspection Observations Preview.

<sup>76</sup> See 2019 Inspection Observations Preview at 4.

<sup>77</sup> See 2018 Inspection Observations Preview at 2.

### iii. Root cause analysis of identified deficiencies

Identifying causal factors for engagement and QC deficiencies (i.e., root cause analysis) can enable a firm to determine the appropriate response to and remediation of deficiencies and modify policies and procedures to prevent similar occurrences in the future. We have observed that thorough root cause analyses drive better remediation of identified deficiencies. If root cause analysis is performed by a centralized team, having a defined process to share data and lessons learned outside of the root cause analysis team may further enhance performance of a firm's QC system.

Through our inspection activities we have observed that some firms' root cause analysis programs have significantly evolved since the PCAOB was formed. We have observed that some firms' approach to root cause analysis includes one or more of the following:

- Interviews with engagement teams and firm leadership;
- Use of proprietary tools to analyze large amounts of data;
- Root cause analysis training and the use of templates to facilitate consistency;
- Consideration of available performance metrics, such as engagement hours, training records, audit milestone dates, and partner experience years; and
- Consideration of positive quality events (i.e., actions, behaviors, or conditions that resulted in positive outcomes, such as where aspects of the firm's QC system operated effectively or where no engagement deficiencies were identified for individual engagements) to identify whether such actions, behaviors, or conditions were present on engagements where QC deficiencies were identified.

### iv. Timely monitoring and evaluation activities

Timely and effective monitoring activities drive high-quality audits. We have observed several good practices followed by some firms in their monitoring activities, including:

- Increased real-time monitoring of in-process audit engagements, for example, through preissuance reviews or coaching programs;<sup>78</sup>
- Formalized monitoring processes and actions for defined triggering events, including restatements, internal and external inspection results, and results of peer reviews; and

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<sup>78</sup> See 2020 Inspection Observations Preview at 4 and 13.

- Mature QC processes including internal self-certifications of the effectiveness of QC components and sub-components.

## B. Other Developments Since the Adoption of Current PCAOB QC Standards

Since the PCAOB's current QC standards were first developed and issued, the auditing environment has changed significantly. The current QC standards were developed in the context of the self-regulatory peer review system that existed before the establishment of the PCAOB. Therefore, they were not written with a view to inspection and enforcement by a regulator and do not address the current regulatory environment, including firms' responsibilities with respect to information brought to their attention through our inspection process.

Since the QC standards were established, there have been significant developments in the availability and use of technologies and data analytic techniques, the organizational structure and management of firms have changed, and some firms have significantly increased their focus on governance and quality control.

For example, there have been significant developments in the use of technology by firms in relation to QC activities and performing engagements. Some firms have made significant investments in internally developed tools for use in the audit. The increased availability of "off-the-shelf" technologies, such as analytical software packages, has made some tools more readily available for use by firms. Firms developing or acquiring new technology-based tools, making changes to existing tools, and training firm personnel on how and when to use such tools have had impacts on QC. Many of these tools may reduce risk, for example by reducing the possibility of human error and enabling the analysis of whole populations of transactions rather than samples. But they may also create new risks if they do not work as intended or are used incorrectly.

Furthermore, some firm management and organizational structures have evolved to include more focus on centralization and a globally consistent methodology. Some firms have increased their use of services and resources supplied by firm networks, affiliates, and third-party service providers. For example, some global networks are increasingly imposing requirements on member firms regarding the use of methodologies, technology, and policies and procedures that are developed or established at the network level. Some firms have also increased their use of shared service centers to assist with QC activities or performing engagements. In addition, some firms have changed their governance structures either

voluntarily or due to changes in legal requirements.<sup>79</sup> At the same time, some firms have begun to publish “transparency reports” that seek to inform the public about the firm’s operations and quality control systems and practices.

Additionally, some firms have strengthened their approaches to firm governance and leadership, incentive systems, and accountability. For example, some firms have added external parties to oversight roles. Some firms have also augmented their monitoring and remediation processes, including through implementing or enhancing ongoing monitoring activities and internal inspection processes, establishing processes for considering PCAOB inspection findings, performing root cause analysis, and increasing remediation efforts. Observations from our oversight activities have shown that improvements in quality controls can enhance the quality of audits.<sup>80</sup> However, as noted above, our inspections continue to identify deficiencies for some firms, suggesting that not all firms have made meaningful improvements in these areas.

There have also been notable advances in internal control, quality management, and enterprise risk management frameworks and approaches, including the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) framework for internal control<sup>81</sup> and the International Organization for Standardization (“ISO”) quality control standard ISO 9000:2015.<sup>82</sup> Many of these share important commonalities, stressing active involvement of leadership, focus on risk, clearly defined objectives, objective-oriented processes, monitoring, and remediation of identified issues. Academic research suggests that these frameworks improve company performance.<sup>83</sup>

### C. PCAOB Outreach and Research, Including the QC Concept Release

The Board and its advisory groups have long considered the potential for improvements to PCAOB QC standards. For example, in 2010, the Standing Advisory Group (“SAG”) discussed a potential QC rulemaking project, including considerations and potential challenges in designing

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<sup>79</sup> See, e.g., the audit firm governance codes of the UK Financial Reporting Council *available at* <https://www.frc.org.uk/getattachment/5af7cdb7-a093-4da8-94d7-f4486596e68c/FRC-Audit-Firm-Governance-Code-April-2022.pdf>, and the Japan Financial Services Agency, *available at* <https://www.fsa.go.jp/news/28/sonota/20170331-auditfirmgc/3.pdf>.

<sup>80</sup> See, e.g., 2018 Inspection Observations Preview at 1-4.

<sup>81</sup> See, e.g., COSO, *Internal Control—Integrated Framework* (May 2013). An executive summary of COSO’s internal control framework is *available at* <https://www.coso.org/Shared%20Documents/Framework-Executive-Summary.pdf>.

<sup>82</sup> More information about ISO 9000:2015 is *available at* <https://www.iso.org/standard/45481.html>.

<sup>83</sup> See Section VI.C.1.a, Benefits of Related Frameworks.

and implementing a QC system.<sup>84</sup> In 2014, the SAG discussed how QC standards may benefit from stronger requirements and other enhancements with respect to, for example, firm culture and tone at the top, firm risk assessment, and monitoring of the quality control system, including use of root cause analyses.<sup>85</sup> In 2018, the SAG discussed whether additional or more specific direction in the quality control standards with respect to governance and leadership would lead to enhancements in firm quality control systems.<sup>86</sup> SAG members have generally supported including requirements concerning firm governance and leadership in PCAOB QC standards.

On December 17, 2019, we issued the concept release to explore the possibility of revising PCAOB QC standards. The concept release described an approach similar to the approach taken by the then-proposed ISQM 1, with certain differences and alternative requirements to specifically address the PCAOB's objectives, including establishing requirements that:

- Align with U.S. federal securities law, SEC rules, and other PCAOB standards and rules;
- Retain important topics in current PCAOB QC standards;
- Address specific emerging risks and problems observed through our oversight activities; and
- Provide more definitive direction to prompt appropriate implementation of certain requirements.<sup>87</sup>

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<sup>84</sup> See Briefing Paper for the Standing Advisory Group, *Designing and Implementing a System of Quality Control* (Oct. 13, 2010). An archive of SAG meeting agendas, briefing papers, and webcasts is available at <https://pcaobus.org/about/advisory-groups/archive-advisory/standing-advisory-group/sagmeetingarchive>. The materials for the October 13-14, 2010 SAG meeting are available at [https://pcaobus.org/news-events/events/event-details/standing-advisory-group-meeting\\_476](https://pcaobus.org/news-events/events/event-details/standing-advisory-group-meeting_476).

<sup>85</sup> See Briefing Paper for the Standing Advisory Group, *Initiatives to Improve Audit Quality—Root Cause Analysis, Audit Quality Indicators, and Quality Control Standards* (June 24, 2014) (“June 2014 SAG Briefing Paper”). The materials for the June 24-25, 2014 SAG meeting are available at [https://pcaobus.org/news-events/events/event-details/pcaob-standing-advisory-group-meeting\\_772](https://pcaobus.org/news-events/events/event-details/pcaob-standing-advisory-group-meeting_772).

<sup>86</sup> See Briefing Paper for the Standing Advisory Group, *Quality Control: Governance and Leadership* (Nov. 29, 2018). The materials for the November 29, 2018 SAG meeting are available at [https://pcaobus.org/news-events/events/event-details/standing-advisory-group-meeting\\_1137](https://pcaobus.org/news-events/events/event-details/standing-advisory-group-meeting_1137).

<sup>87</sup> See Concept Release at 6.

We received 36 comment letters in response to the concept release.<sup>88</sup> Commenters included firms and related groups, investors, investor advocates, academics, trade groups, and others. We have considered all comments in developing this proposal, and commenter input is included where relevant in the discussion that follows.

## D. Actions by Other Standard Setters

Following is a brief description of the quality control standards adopted by the IAASB and the AICPA. We highlight the key differences between proposed QC 1000 and these standards in the detailed discussion of the proposed text of QC 1000 that appears in Section IV. A staff document that compares the requirements of proposed QC 1000 to ISQM 1 and SQMS 1 is available on the Board's website in Docket 046.

### 1. IAASB

The IAASB identified concerns related to its current QC standard, International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, and decided to take steps to improve the standard. In December 2020, the IAASB released a suite of new quality management standards, including ISQM 1.<sup>89</sup> The new standards will become effective on December 15, 2022.

ISQM 1 sets forth:

- Eight components that operate in an iterative and integrated manner:
  - The firm's risk assessment process;
  - Governance and leadership;
  - Relevant ethics requirements;

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<sup>88</sup> The comment letters received in response to the concept release are available on the Board's website in Docket 046.

<sup>89</sup> In addition to ISQM 1, the IAASB adopted two other standards, International Standard on Quality Management 2, *Engagement Quality Reviews* ("ISQM 2"), and International Standard on Auditing 220 (Revised), *Quality Management for an Audit of Financial Statements* ("ISA 220 (Revised)"). ISQM 2 will operate at the firm level, and is analogous to our AS 1220, *Engagement Quality Review*. ISA 220 (Revised) will operate at the engagement level and deals with the engagement partner's and the engagement team's responsibilities for quality management for an audit of financial statements. Similar topics are addressed in PCAOB standards in AS 1201, *Supervision of the Audit Engagement*.

- Acceptance and continuance of client relationships and specific engagements;
  - Engagement performance;
  - Resources;
  - Information and communication; and
  - Monitoring and remediation process.
- Other requirements:
    - Roles and responsibilities for the system;
    - Leadership's overall evaluation of the system;
    - Network requirements or network services; and
    - Documentation.<sup>90</sup>

## 2. AICPA

In May 2022, the Auditing Standards Board of the AICPA adopted new quality management standards designed to improve a firm's risk assessment and audit quality, including SQMS 1.<sup>91</sup> The AICPA's quality management standards closely align with the IAASB's quality management standards, adapted for private companies in the United States. The new standards will become effective on December 15, 2025.

### E. Areas of Potential Improvement to the QC Standards

Based on the foregoing considerations, we preliminarily believe that our QC standards could be improved, thereby leading firms to improve their QC systems, by:

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<sup>90</sup> See IAASB Fact Sheet, *Introduction to ISQM 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* (Dec. 2020), available at <https://www.ifac.org/system/files/publications/files/IAASB-ISQM-1-Fact-Sheet.pdf>.

<sup>91</sup> The AICPA's other QC standards are SQMS No. 2, *Engagement Quality Reviews*; Statement on Auditing Standards (SAS) No. 146, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*; and Statement on Standards for Accounting and Review Services (SSARS) No. 26, *Quality Management for an Engagement Conducted in Accordance With Statements on Standards for Accounting and Review Services*.

- Expressly requiring a risk-based approach to QC, with well-defined quality objectives and a systematic effort to identify and proactively manage risks to the firm’s achieving those objectives;
- Emphasizing firm governance, the “tone at the top,” and individual accountability;
- Providing more direction regarding monitoring activities and remediation of identified deficiencies to encourage an ongoing feedback loop that drives continuous improvement;
- Addressing changes in the audit practice environment, including the increasing participation of other firms and other outside resources, the role of firm networks, the evolving use of technology and other resources, and the increasing importance of internal and external firm communications;
- Providing for a rigorous annual evaluation of a firm’s QC system;
- Introducing annual QC reporting to the PCAOB to underscore the importance of rigorous annual evaluation of the QC system and support PCAOB oversight; and
- Requiring enhanced communication to the audit committee.<sup>92</sup>

Our preliminary view is that the basic objectives of the QC system should be the same across all firms, but that there should be differences in the requirements and extent of applicability of the QC standard depending on the nature and circumstances of the firm.

For firms that are performing or playing a substantial role in engagements under PCAOB standards, the specific policies and procedures necessary to achieve the objectives of the QC system could vary significantly across firms, depending on their size, the types of engagements they perform, and other factors. We believe that our QC standard should be sufficiently principles-based and scalable that firms could pursue an approach to QC that is appropriate in light of their specific circumstances.

Our preliminary view is that firms that perform engagements under PCAOB standards should generally be subject to the same QC requirements. We are considering whether there may be specific areas, such as firm governance, where larger firms should be subject to enhanced requirements. In particular, we do not believe the historical distinction between firms that were members of the SECPS in 2003 and those that were not has continuing relevance in determining the QC standards that should apply today. Accordingly, we propose to

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<sup>92</sup> See paragraph .A2 of AS 1301, *Communications with Audit Committees*, for the definition of audit committee.

eliminate that distinction. As discussed in more detail below, QC 1000 would incorporate certain SECPS requirements, making them applicable to all firms, and would eliminate others.

We are aware that there is a significant number of registered firms that do not perform engagements under PCAOB standards every year. Our preliminary view is that the risk to investor protection is minimal if the firm is not performing or playing a substantial role in engagements for issuers and SEC-registered broker-dealers, and that it would be appropriate to provide for more limited QC obligations in those circumstances.

### III. PROPOSED QC 1000: BASIC STRUCTURE, TERMINOLOGY, AND SCALABILITY

This section summarizes the basic structure of proposed QC 1000 and introduces important terminology, including the terms proposed to describe the various individuals and organizations whose activities would be covered by QC 1000. It also describes the distinction made in the proposed standard between firms that would be required to design a QC system that complies with QC 1000 and firms that would be required to design, implement, and operate the QC system, and highlights other considerations around scalability of the proposed standard.

#### A. Basic Structure

##### 1. Considerations informing the structure of QC 1000

In the concept release, we solicited comment on whether it would be appropriate to use ISQM 1 as the starting point for a future PCAOB QC standard. Most commenters supported that approach, although two commenters suggested alternatives: an audit framework based on consultation with the IT Governance Institute, and ISO 9001, which is an international standard for quality management systems intended to be usable by organizations of all types, sizes, and sectors.<sup>93</sup>

Informed by our observations and assessment of changes to auditing practice, we preliminarily believe that critical characteristics of any new QC standard include being risk-based and scalable. Moreover, we believe that any new QC standard should be designed to foster a proactive approach to QC that drives continuous improvement. Further, based in part on our observations, our current view is that any new standard should include specific requirements for some important areas of the QC system that are addressed more generally in our current QC standards. As discussed below, while the approach taken in ISQM 1 and the AICPA's SQMS 1 has informed our thinking, we have carefully analyzed every aspect of that approach and considered where to align and where to include alternative or incremental provisions that we believe may better serve investor protection and the public interest.

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<sup>93</sup> See ISO 9001, *Quality Management Systems—Requirements*.

We are proposing to structure QC 1000 in a similar manner as ISQM 1 and the AICPA's SQMS 1. We preliminarily believe that building on a common basic structure with other audit standard setters, with appropriate differences, would enable us to accomplish the intended improvements to our QC standards outlined above more effectively, as well as more efficiently and at a lower relative cost to the firms we regulate. In designing, implementing, and operating their QC systems, firms that are subject to both PCAOB standards and IAASB or AICPA QC standards—which we believe is a very substantial majority of firms that perform engagements under our standards<sup>94</sup>—could leverage the investments they make to comply with the requirements of the IAASB and AICPA, and would avoid the additional costs that would be associated with fundamentally different, and potentially conflicting, approaches to QC.

Proposed QC 1000 incorporates the same eight components as ISQM 1 and SQMS 1. These components cover all the areas of QC that Sarbanes-Oxley requires our QC standards to address and would provide a robust framework for the other substantive improvements we are proposing. In fact, the structure itself addresses many of the ways in which we propose to improve our standards; for example, it is risk-based, and it includes specific provisions in areas such as firm governance and leadership, technology and other firm resources, and firm communications, which our current standards do not directly address. Because it is principles-based and focused on the specific risks faced by the firm, we also believe the basic structure is inherently scalable and could be applied to firms of all sizes and circumstances.

Using the same basic structure as the IAASB and AICPA QC standards does not limit our ability to develop a QC standard that is appropriately tailored to firms that perform engagements under PCAOB standards. Our proposal includes important additional or modified provisions that we preliminarily believe address our particular environment and the needs and priorities of our stakeholders. As a result, our proposal does not completely align with the IAASB and AICPA QC standards.

We note that the basic structure of ISQM 1 and SQMS 1 has much in common with ISO 9001, an alternative approach suggested by one commenter. ISO 9001 is also risk-based, intended for use by organizations of all sizes, and built on a process approach to enable consistent, effective performance and improvement of processes based on evaluation of data and information.<sup>95</sup> However, the basic structure of ISQM 1 and SQMS 1 reflects a risk-based, process-oriented approach to QC in the particular context of firms that perform audits or provide assurance over financial statements, whereas ISO 9001 provides generic requirements that are intended to be applicable to any kind of organization, regardless of its type or size or

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<sup>94</sup> See VI.A.5 for a discussion on the assumptions regarding the baseline.

<sup>95</sup> See ISO 9001.0.1, .0.3.1.-.3, available at <https://www.iso.org/obp/ui/#iso:std:iso:9001:ed-5:v1:en>. ISQM 1's risk-based approach to quality management systems also is similar in principle to the COSO framework.

the products or services it provides.<sup>96</sup> As a result, the structure of ISQM 1 and SQMS 1 is more detailed and, in our view, better tailored to the needs of firms performing engagements under PCAOB standards than ISO 9001.

We also considered the commenter suggestion to develop an audit framework based on consultation with the IT Governance Institute, a branch of ISACA (formerly known as the Information Systems Audit and Control Association). ISACA has developed an Information Technology Audit Framework that provides guidance on the design, conduct, and reporting of information technology (“IT”) audit and assurance assignments; defines terms and concepts specific to IT assurance; and establishes standards that address IT audit and assurance professional roles and responsibilities, knowledge and skills, and diligence, comfort, and reporting requirements.<sup>97</sup> While there may be some similarities, including a focus on risk assessment, this framework is specifically tailored to IT audits and does not address quality control. For that reason, in our view, it is not as well suited to our needs as is the framework of ISQM 1 and SQMS 1.

## 2. Reasonable assurance

Under proposed QC 1000, the objective of the QC system would be to provide reasonable assurance as to compliance with the professional and legal requirements that apply to the firm’s engagements. In this respect, proposed QC 1000 aligns with our current QC standards, as well as ISQM 1 and SQMS 1, all of which contemplate that the system of QC should provide reasonable assurance.<sup>98</sup>

In the concept release we asked whether the objective of the quality management system provided in ISQM 1 would be appropriate for a QC system under PCAOB standards. Most commenters, including firms and related groups, supported that objective. Many commenters, generally firms, emphasized specifically that a firm’s QC system should provide reasonable assurance, not absolute assurance. Some firms asserted that a QC system could not be designed to achieve absolute assurance given uncertainties in judgments, unpredictable risks, and related human error.

One firm suggested that we provide clarification of the meaning of “reasonable assurance” in the context of the firm’s QC system. We believe the concept should be familiar since, in addition to being incorporated in ISQM 1 and SQMS 1, it is currently being used in

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<sup>96</sup> See Abstract of ISO 9001, available at <https://www.iso.org/standard/62085.html>.

<sup>97</sup> More information about ISACA and its IT Audit Framework is available at <https://www.isaca.org/>.

<sup>98</sup> See ISQM 1.14; SQMS 1.15.

existing PCAOB QC, auditing, and attestation standards,<sup>99</sup> U.S. federal securities law,<sup>100</sup> and risk management frameworks, such as COSO.<sup>101</sup> Reasonable assurance is a high level of assurance but not absolute assurance. The concept acknowledges inherent limitations in every system, whether it is the firm's QC system, a company's system of ICFR, or another system. It recognizes the fact that uncertainties and risks may exist and cannot be predicted with exact precision. Even in a well-designed system, there is a risk of human error, uncertainty in judgment, or potential impact of external events outside the firm's control.

Our preliminary view is that it would be appropriate to calibrate the QC system to provide reasonable assurance. Reasonable assurance is grounded in auditors' existing obligations and we believe can be interpreted and applied consistently.

The proposed objective of the QC system is discussed in more detail in Section IV.B.1 below.

### **3. Components of the QC system**

Under proposed QC 1000, the QC system would consist of eight components that are designed to be highly integrated:

#### **Two process components**

- The firm's risk assessment process
- The monitoring and remediation process

#### **Six components that address aspects of the firm's organization and operations**

- Governance and leadership
- Ethics and independence
- Acceptance and continuance of client relationships and specific engagements
- Engagement performance

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<sup>99</sup> See generally, e.g., QC 20; AS 1015, *Due Professional Care in the Performance of Work*; AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*; Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*.

<sup>100</sup> See Section 103(a)(2)(A)(iii)(II)(bb) of Sarbanes-Oxley; Rule 13a-15(f) under the Securities Exchange Act of 1934 ("Exchange Act"), 17 C.F.R. § 240.13a-15(f).

<sup>101</sup> See COSO, *Internal Control—Integrated Framework*.

- Resources
- Information and communication

The risk assessment process would apply to these six components, requiring firms to:

- Establish outcome-based “quality objectives” (i.e., the desired outcomes to be achieved by the firm with respect to that component);<sup>102</sup>
- Identify and assess “quality risks” to the quality objectives;<sup>103</sup>
- Design and implement “quality responses” (i.e., policies and procedures to address quality risks);<sup>104</sup> and
- Establish policies and procedures to monitor internal and external changes that may require modifications to the quality objectives, quality risks, or quality responses.

The monitoring and remediation process would apply to all of the components of the QC system, including monitoring and remediation itself (i.e., firms would be required to monitor and remediate deficiencies that are observed in their monitoring and remediation activities).

The firm is also required to evaluate and report on its QC system annually, based on the results of its monitoring and remediation activities.

The following diagram illustrates the structure of the firm’s QC system under proposed QC 1000:

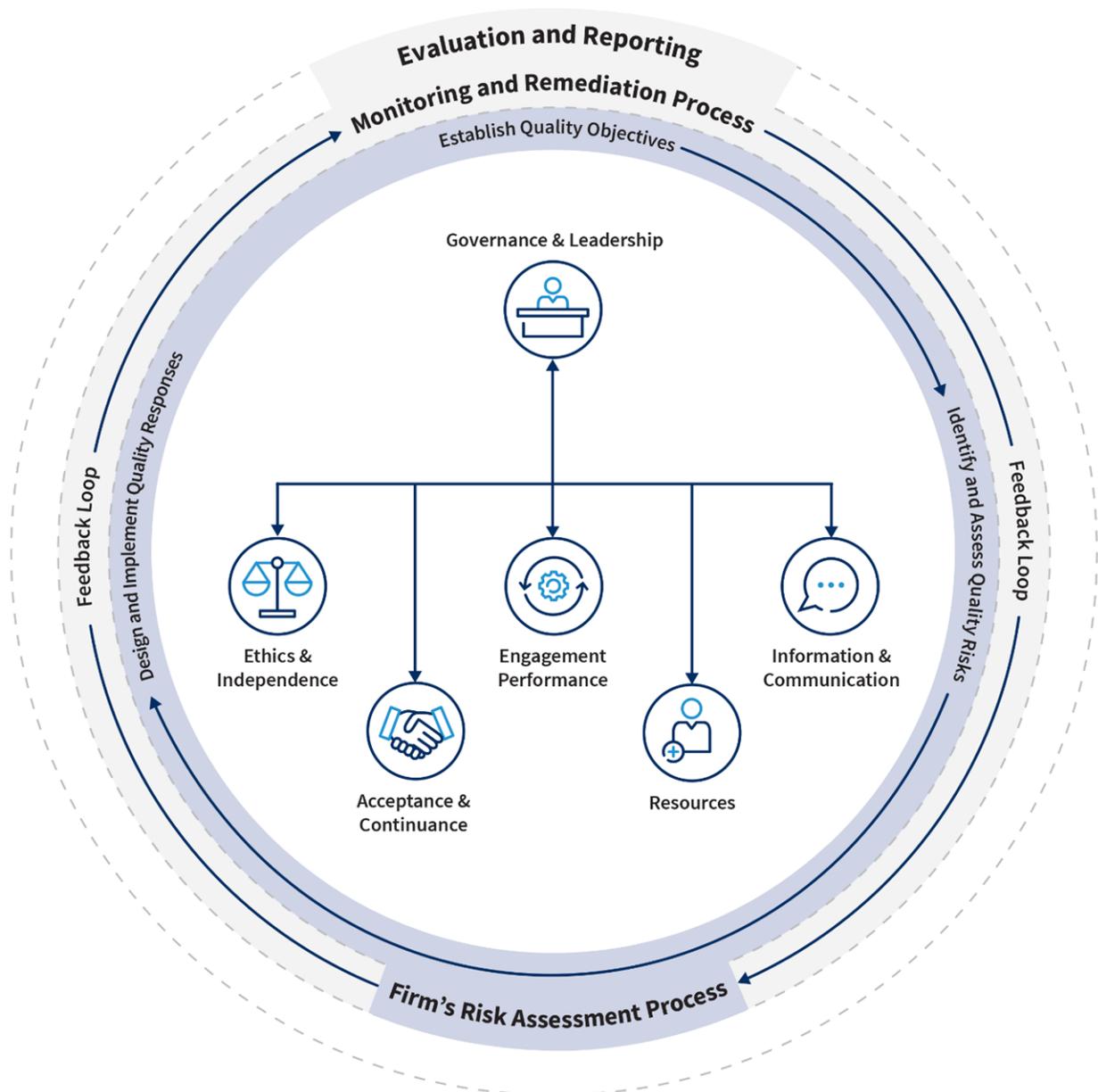
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<sup>102</sup> “Quality objectives” are defined in paragraph .A10 of Appendix A to proposed QC 1000.

<sup>103</sup> “Quality risks” are defined in paragraph .A12 of Appendix A to proposed QC 1000.

<sup>104</sup> “Quality responses” are defined in paragraph .A11 of Appendix A to proposed QC 1000.

Structure of the Firm's QC System



**4. Quality objectives, quality risks, and quality responses, including specified quality responses**

For each of the six components to which the risk assessment process applies, proposed QC 1000 specifies required quality objectives. We believe that, for many firms, the quality

objectives specified in the proposed standard would likely be comprehensive, and we do not expect in our current environment that additional quality objectives would generally be necessary. However, we also recognize that the nature and circumstances of a firm and its engagements will vary and the environment may change. Accordingly, firms would be required to establish additional quality objectives, if necessary.<sup>105</sup>

Firms would be required to identify and assess quality risks to the achievement of the established quality objectives. They would also be required to develop quality responses—policies and procedures—to address the assessed quality risks.

The correspondence across quality objectives, quality risks, and quality responses is generally not one-to-one. Most quality objectives are likely to have multiple quality risks. Some quality risks may affect one or more quality objectives, either within a single component or across several components, and may require multiple quality responses. Some quality responses may address multiple quality risks.

Quality responses would typically be specific to the firm, to respond to its particular assessed quality risks. Proposed QC 1000 also includes some specified quality responses that we believe relate to risks that apply to all firms, and that would be required to be addressed by all firms. Some proposed specified quality responses are similar to ISQM 1, while others carry requirements from our current standards into proposed QC 1000 or provide more clarity about the outcomes to be achieved and actions expected to be taken by firms and individuals. The proposed specified quality responses are not intended to be comprehensive; on the contrary, for most of the components of the firm's QC system, the proposed standard includes only a few specified quality responses, and for the engagement performance component there are none. As a result, the specified quality responses alone would not be sufficient to enable the firm to achieve all established quality objectives; firms would also be required to design and implement their own quality responses. Both the specified quality responses and the quality responses the firm designs and implements on its own would be critical in addressing quality risks. The following graphic illustrates the relationship between all quality responses (i.e., the quality responses necessary to achieve all established quality objectives) and the specified quality responses established in proposed QC 1000:

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<sup>105</sup> See Section IV.D, The Firm's Risk Assessment Process.

## The Relationship Between Quality Responses and Specified Quality Responses



### B. Terminology

This section discusses some of the terminology used throughout proposed QC 1000. Appendix A to QC 1000 defines several terms used in the proposed standard.

#### 1. Applicable professional and legal requirements

The proposed standard defines “applicable professional and legal requirements” as

- Professional standards, as defined in PCAOB Rule 1001(p)(vi);
- Rules of the PCAOB that are not professional standards; and
- To the extent related to the obligations and responsibilities of accountants or auditors or to the conduct of engagements, rules of the SEC, other provisions of U.S. federal securities law, and other applicable statutory, regulatory, and other legal requirements.

This definition is intended to capture all professional and legal requirements specifically related to engagements under PCAOB standards of issuers and SEC-registered broker-dealers, including relevant accounting, auditing, and attestation standards, PCAOB and SEC rules, other provisions of federal securities law, other relevant laws and regulations (e.g., state law and rules governing accountants), and other legal requirements related to the obligations and responsibilities of accountants or auditors or to the conduct of the firm's engagements.<sup>106</sup> As discussed in more detail in Section IV, compliance with applicable professional and legal requirements is a fundamental concept under proposed QC 1000, driving the objective of the QC system as well as many quality objectives and specified quality responses.

## 2. Engagement

The proposed standard defines "engagement" as any audit, attestation, review, or other engagement under PCAOB standards performed by a firm or in which a firm "play[s] a substantial role in the preparation or furnishing of an audit report" as defined in PCAOB Rule 1001(p)(ii).<sup>107</sup> The definition covers not only circumstances in which the firm serves as the lead auditor or the "practitioner" for an attestation engagement, which is what is customarily meant by the term engagement, but also any substantial role work the firm undertakes. Our initial view is that this additional breadth is appropriate because playing a substantial role in an engagement for an issuer or broker-dealer audit is sufficient to require a firm to register with the PCAOB. The definition covers all engagements under PCAOB standards performed by the firm, whether the application of PCAOB standards is legally required (e.g., for audits of issuers and broker-dealers) or undertaken pursuant to contractual agreement, where permitted but not required under SEC rules, or for any other reason.

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<sup>106</sup> For avoidance of doubt, the proposed requirements relating to compliance with applicable professional and legal requirements are meant to make clear that, as relates to engagements subject to PCAOB standards, all applicable professional and legal requirements must be followed. The proposed requirement does not suggest that application of "other applicable statutory, regulatory, and other legal requirements" could supersede rules of the Securities and Exchange Commission ("SEC"), other provisions of U.S. federal securities law, rules of the PCAOB that are not professional standards, or PCAOB professional standards. On the contrary, requirements relating to "applicable professional and legal requirements" are meant to highlight the importance of adhering to other requirements when those requirements do not conflict with or abridge requirements of federal securities laws, PCAOB rules or PCAOB standards.

<sup>107</sup> Generally, and as described in more detail in Rule 1001(p)(ii), a firm plays a substantial role in the preparation or furnishing of an audit report if (1) its engagement hours or fees constitute 20% or more of the total engagement hours or fees or (2) it performs the majority of the audit procedures with respect to a subsidiary or component whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the issuer, broker, or dealer.

The concept of “engagement” also marks an important distinction in the level of responsibility created under proposed QC 1000: while all registered firms would be required to design a QC system that complies with QC 1000, the proposed threshold for a firm to implement and operate the QC system is when the firm has responsibilities under applicable professional and legal requirements with respect to a firm engagement. The distinction between scaled applicability under proposed QC 1000 (for firms that do not perform engagements) and full applicability of proposed QC 1000 (for firms that do perform engagements), is discussed in more detail in Section III.C below.

Once required to be implemented and operated, the QC system would apply to all work performed under PCAOB standards, including work on other firms’ PCAOB engagements below the level of a substantial role (sometimes called referred work). If a firm is required to implement and operate a QC system under QC 1000, we believe that the QC system should address every engagement under PCAOB standards in which the firm participates.

### **3. Engagement partner**

The proposed standard uses the term “engagement partner” with its existing meaning under our audit and attestation standards: the member of the engagement team<sup>108</sup> with primary responsibility for the audit, examination, or review, as the case may be.<sup>109</sup> We do not intend for the proposed definition of “engagement” under QC 1000, under which substantial role work is defined as an engagement, to change the meaning of engagement partner or to affect the responsibilities of individuals involved in substantial role engagements.

### **4. Firm personnel**

The proposed standard defines “firm personnel” as individual proprietors, partners, shareholders, members or other principals, accountants, and professional staff of a registered public accounting firm whose responsibilities include assisting with: (1) the performance of the firm’s engagements; or (2) the design, implementation, or operation of the firm’s QC system, including engagement quality reviews. Professional staff refers not only to employees, but also to other individuals who work under the firm’s supervision or direction and control and

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<sup>108</sup> The term “engagement team” is used as defined in the amendments to AS 2101, *Audit Planning*, adopted in *Planning and Supervision of Audits Involving Other Auditors and Dividing Responsibility for the Audit with Another Accounting Firm*, PCAOB Release No. 2022-002 (June 21, 2022).

<sup>109</sup> See AS 1201, *Supervision of the Audit Engagement*, at paragraph .A1; AT No. 1 at paragraph .07 note; AT No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* at paragraph .06 note. AT 101, *Attest Engagements*, uses the term “practitioner with final responsibility for the engagement,” which we construe as having the same meaning.

function as the firm's employees. For example, secondees and leased staff would fall under the proposed definition of "firm personnel."

## 5. Other participants

Over the years, audits of issuers have increasingly involved the use of entities and individuals outside the firm in performing audit procedures and evaluating audit evidence. For example, we recently discussed the increasing prevalence and importance of the use of other audit firms and individual accountants outside the firm, such as an EQR not employed by the firm, and the use of auditor-engaged specialists.<sup>110</sup>

While it may be beneficial, and in many cases essential, to use other participants in some engagements, these arrangements can pose risks because other participants may not be subject to the same quality controls as firm personnel (for example, with regard to personnel assignments, training, supervision, and monitoring). In the concept release, we indicated that we were considering how a future PCAOB QC standard should address quality controls over the firm's use of other audit participants.

The concept release discussed potential incremental provisions related to other participants in the audit, such as having quality controls that address evaluating their knowledge, skill, and ability and their independence or objectivity; coordination between firm personnel and other participants; and the supervision of other participants' work. The concept release also asked if the new standard should address affiliated and non-affiliated entities and individuals, including specialists and service delivery centers, also known as shared service centers.

Some firms commented that requirements for other participants should be addressed in auditing standards and not the QC standard. However, most commenters, including firms and related groups, supported having requirements to address other participants, generally based on the principles in ISQM 1 or a combination of ISQM 1 and the relevant auditing standards. Two commenters specifically mentioned the importance of addressing service delivery centers. Two other commenters cautioned that we should avoid conflicts between a revised QC standard and auditing standards involving other participants.

Under the proposed approach, in designing, implementing, and operating its QC system, the firm would need to address not only firm personnel but also other auditors<sup>111</sup> and other

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<sup>110</sup> See PCAOB Release No. 2022-002, at 13; *Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*, PCAOB Release No. 2018-006 (Dec. 20, 2018), at 10-15.

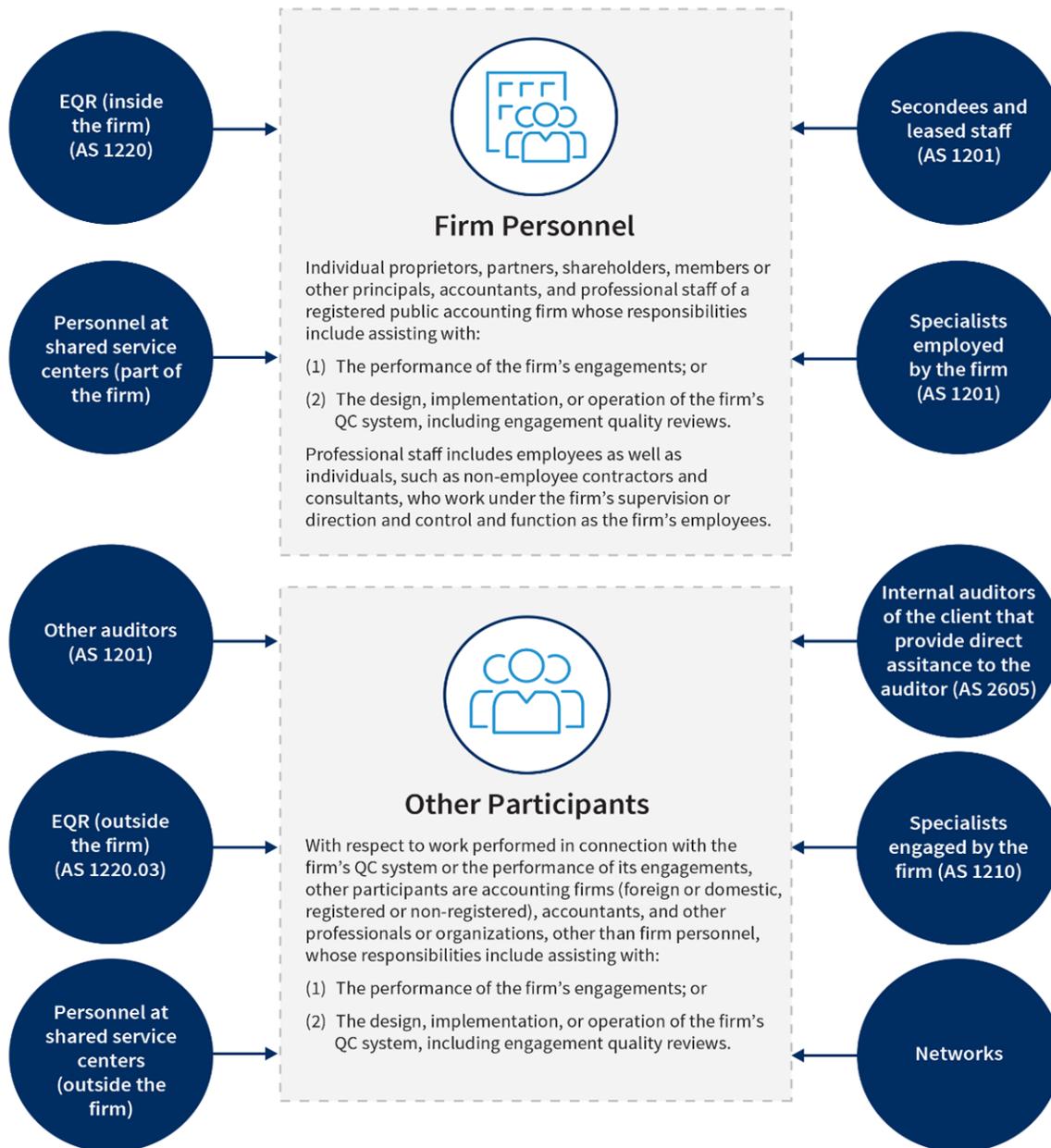
<sup>111</sup> See AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*.

professionals or organizations that the firm uses or plans to use in connection with the firm's QC system or the performance of its engagements.

Accordingly, with respect to work performed in connection with the firm's QC system or the performance of its engagements, proposed QC 1000 defines "other participants" as accounting firms (foreign or domestic, registered or non-registered), accountants, and other professionals or organizations, other than firm personnel, whose responsibilities include assisting with the performance of the firm's engagements or the design, implementation, or operation of the firm's QC system, including engagement quality reviews.<sup>112</sup> The following diagram provides QC 1000's definitions of "firm personnel" and "other participants" and provides examples of each type:

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<sup>112</sup> It should be noted that "referred-to auditors," as that term is defined in the amendments to AS 2101 adopted in PCAOB Release No. 2022-002, are not "other participants" under proposed QC 1000 because the referred-to auditor performs its own engagement and does not participate in the engagement of the lead auditor.



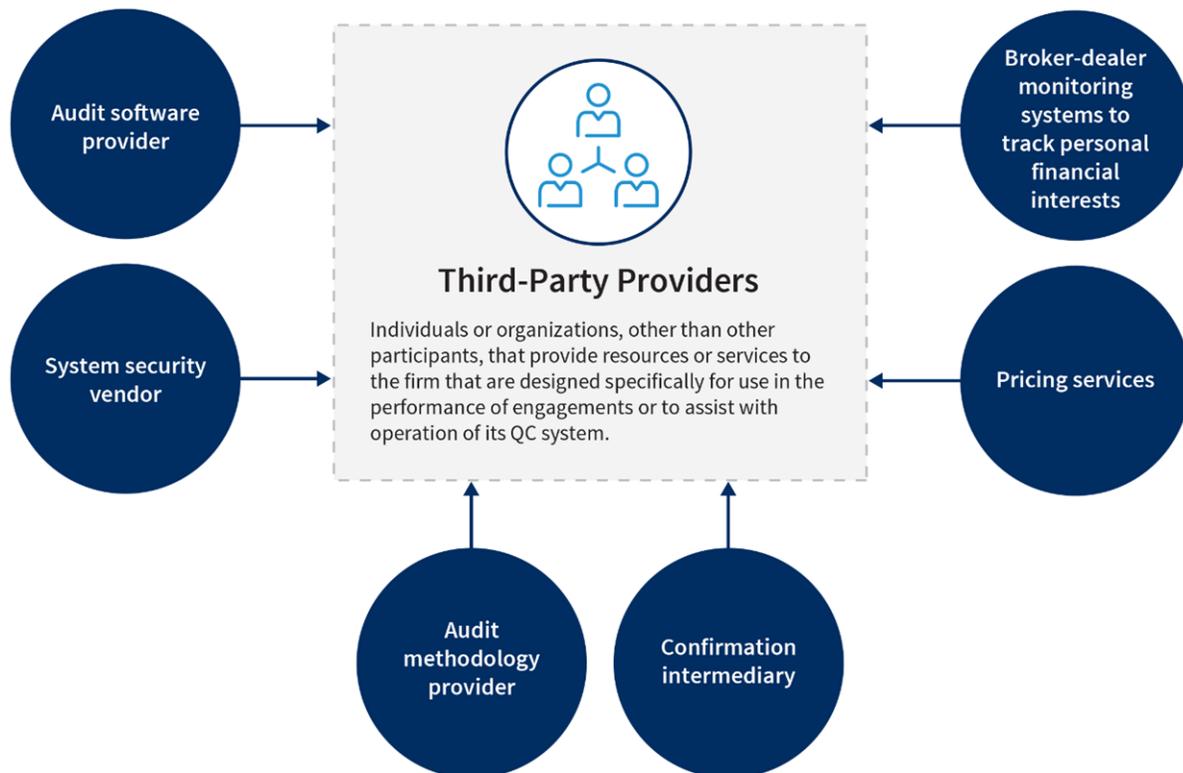
As noted in the diagram, the persons performing some roles, such as an EQR or personnel at shared service centers, may be firm personnel or other participants, depending on their relationship to the firm. For example, an EQR employed by the firm would be considered firm personnel, whereas an EQR contracted from outside the firm that is not functioning as a firm employee would be an other participant. Similarly, personnel at shared service centers may be firm personnel (if they are employed by the firm or function as firm employees) or other participants (if they are employed by another organization, such as a network affiliate).

## 6. Individuals

The proposed standard uses “individuals” to refer to people, whether firm personnel or other participants.

## 7. Third-party providers

The proposed standard addresses resources used by the firm that are sourced from third-party providers. Third-party providers are individuals or organizations, other than other participants, as defined above, that provide resources to the firm that are specifically designed for use in the performance of engagements or to assist in the operation of its QC system.<sup>113</sup> The following diagram provides QC 1000’s proposed definition of “third-party providers” and several examples of them:



<sup>113</sup> Providers of resources that are not specifically designed for use in the performance of engagements or to assist in the operation of firms’ QC systems (e.g., general word processing and spreadsheet software) would not be “third-party providers” as we propose to define that term.

## 8. Networks

Proposed QC 1000 acknowledges that networks of firms may be structured in a variety of ways and could include arrangements between firms for sharing knowledge; developing and implementing consistent policies, tools, and methodologies; conducting multi-location engagements; or executing other types of business or client service matters. Through our oversight activities, we have observed that some networks provide or require use of a wide range of resources and services and may involve various levels of personnel, composed of a mix of the firm's national and local office personnel. Some examples of resources and services that networks provide include:

- Audit methodologies;
- Technology tools;
- Training;
- Risk management activities;
- Consultations on accounting, auditing, and SEC matters;
- Preventive engagement-level monitoring and coaching;
- Support for inspections; and
- Root cause analysis and remediation.

Since networks may involve a wide variety of different arrangements and different degrees of coordination and cooperation across firms, rather than attempting to define the term "network," proposed QC 1000 describes these types of arrangements in more general terms.<sup>114</sup> Under the proposed standard, networks may include a combination of registered and unregistered accounting firms and other entities.

## 9. Timely

Several requirements in the proposed standard refer to actions being taken on a "timely basis." In each of these cases, what constitutes "timely" would depend on the underlying matter to which the action relates, including the matter's nature, scope, and impact. Timely

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<sup>114</sup> In the proposed standard, references to a "network" encompass all of the memberships and affiliations that registered firms must report to us in Item 5.2 of their annual report on Form 2, including certain networks, arrangements, alliances, partnerships, and associations. See Item 5.2, PCAOB Form 2 (describing reporting requirements for memberships, affiliations, and similar arrangements).

action should be sufficiently prompt to achieve its objective. In some cases, for example, where there is a high risk of a severe or pervasive problem, action may have to be immediate to be timely.

### C. Scalability

The approximately 1,700 firms registered with us differ significantly based on their nature and circumstances:

- Approximately 51% of firms are located in foreign jurisdictions, representing 90 foreign jurisdictions;
- Approximately 20% of total firms, and 40% of firms located in foreign jurisdictions, are members of networks that share resources such as methodology and monitoring activities;
- Approximately 70 firms are sole proprietorships;
- Approximately 700 firms, or 41% of firms, performed an engagement under PCAOB standards for an issuer or broker-dealer in 2021;
  - Approximately 85 only played a substantial role in the audit in the past year;
  - Approximately 160 performed audits of only broker-dealers in the past year;
- Approximately 150 firms that did not perform an engagement under PCAOB standards for an issuer or broker-dealer in 2021 did perform such an engagement in the past five years; and
- Approximately 49% of firms have not performed an engagement under PCAOB standards for an issuer or broker-dealer in the past five years.<sup>115</sup>

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<sup>115</sup> The data was obtained from Audit Analytics and publicly available data from the PCAOB's Registration, Annual and Special Reporting (RASR) available at <https://rasr.pcaobus.org>. We do not collect information about whether registered firms perform engagements under PCAOB standards other than for issuers and broker-dealers. Firms may perform engagements, for example, in connection with the audit of a reporting company that does not meet the Sarbanes-Oxley definition of "issuer" described in footnote 2 above, in connection with certain offerings of securities that are exempt from registration under the Securities Act (e.g., offerings under Regulation A, Regulation D, or Regulation Crowdfunding), pursuant to a contractual obligation such as a loan covenant, or on an entirely voluntary basis.

We believe the QC standard needs to be appropriately scalable, so that firms of different sizes and characteristics could appropriately design their QC system to address the risks associated with their own practice.

### **1. Scaled applicability vs. full applicability**

We are proposing a fundamental distinction in QC 1000 between the obligation to design a QC system in compliance with the proposed standard, which would apply to all firms,<sup>116</sup> and the obligation to implement and operate an effective QC system, which, broadly speaking, would apply only to firms that perform engagements under PCAOB standards.<sup>117</sup>

Under the proposal, firms would be required to implement and operate an effective QC system—that is, comply with all provisions of proposed QC 1000—at all times that the firm is required to comply with applicable professional and legal requirements with respect to any of the firm’s engagements.<sup>118</sup>

As noted above, many registered firms do not perform engagements every year. However, a firm that is not currently performing any engagements may nevertheless have to comply with applicable professional and legal requirements with respect to a previous or future firm engagement. For example, procedures for the acceptance of a new engagement have to be performed before the engagement is conducted. Responsibilities may also arise with respect to completed engagements long after the issuance of the auditor’s report—for example, if the issuer requests the auditor’s consent to include its report in a registration statement, if an engagement deficiency is identified that requires remediation, or if the auditor becomes aware of facts that may have existed at the date of the auditor’s report which may have affected the report. Our preliminary view is that, whenever a firm has responsibilities under applicable professional and legal requirements with respect to an engagement, those responsibilities should be performed under a fully implemented and operating QC system that complies with PCAOB standards.

Importantly, if a firm were required to implement and operate an effective QC system, under the proposed standard, the firm would not necessarily have to implement and operate every QC policy or procedure that it had designed. An effective QC system would provide reasonable assurance that the firm was complying with "applicable" professional and legal requirements. The extent of "applicable" requirements could change depending on the firm's

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<sup>116</sup> Proposed QC 1000.06, discussed in Part IV.B below, sets out the requirements for QC system design.

<sup>117</sup> As described in Section III.B.2, we propose to define the term “engagement” to include all engagements performed under PCAOB standards, whether required by law or otherwise.

<sup>118</sup> Proposed QC 1000.07.

circumstances, and the policies and procedures that the firm would have to implement and operate could change in response. For example, if a firm last performed an engagement (as defined in the proposed standard) five or six years ago and has no current responsibilities with respect to any other firms' engagements, it might be subject only to requirements regarding the retention of certain engagement-related documentation.<sup>119</sup> In such a circumstance, an effective QC system—i.e., a system that provides reasonable assurance that the firm is complying with applicable professional and legal requirements regarding such documentation—could be scaled back to address only engagement-related documentation retention, as well as ongoing evaluation, reporting, and documentation requirements with respect to the QC system itself.

If the firm had no more responsibilities with respect to any engagement the firm would be required to continue operating the QC system until the next November 30 (annual evaluation date). This would ensure that the firm would be required to evaluate and report on the QC system for any year during which the QC system was required to operate.<sup>120</sup>

Firms that are not subject to the requirement to implement and operate the QC system would still be subject to the requirement to design a QC system that complies with proposed QC 1000.<sup>121</sup> Paragraph .06 of proposed QC 1000, discussed in Section IV.B below, sets out the requirements for design of the QC system in more detail.

Our preliminary view is that it would be appropriate to limit the application of the requirements of QC 1000 for firms that have no obligations under applicable professional and legal requirements with respect to firm engagements. Indeed, in those situations it is hard to see how a firm could, as a practical matter, “implement” or “operate” its QC system. Implementation and operation contemplate, among other things, the application of QC policies and procedures to the firm's engagements, monitoring of work performed on engagements, and identification and remediation of engagement deficiencies. Without “engagements,” as the proposed standard defines that term, implementation and operation of a QC system would be largely hypothetical. Moreover, as proposed, the population of firms that would be subject only to the design requirements of QC 1000 would be comprised entirely of firms that were not required to be registered with the PCAOB—either because they did not perform any work on engagements under PCAOB standards or did so only below the level of a substantial role.

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<sup>119</sup> See AS 1215, *Audit Documentation*; Regulation S-X Rule 2-06, 17 C.F.R. § 210.2-06.

<sup>120</sup> Proposed QC 1000.07. The proposed requirements for evaluation of and reporting on the QC system are discussed in Section IV.L below.

<sup>121</sup> The proposed standard makes clear that any existing obligations under QC 1000 (for example, reporting obligations with respect to prior periods when the firm was required to implement and operate the QC system) would continue.

However, we also believe that requiring all registered firms to design a QC system that complies with the proposed standard, regardless of whether they have obligations with respect to engagements, is consistent with our statutory mandate and historical practice. Sarbanes-Oxley directs us to include in our QC standards requirements for “every” registered public accounting firm related to certain topics.<sup>122</sup> The statute also directs us that applications for registration with the PCAOB must contain “a statement of the quality control policies of the [applicant] for its accounting and auditing practices.”<sup>123</sup> Consistent with that directive, as a condition to registration, applicants are required to furnish “a narrative, summary description, in a clear, concise and understandable format, of the quality control policies of the applicant for its accounting and auditing practices, including procedures used to monitor compliance with independence requirements,”<sup>124</sup> and that description must provide an overview of the applicant’s quality control policies regarding each element of quality control.<sup>125</sup>

We also believe that requiring all firms to design a QC system that complies with our QC standards would be consistent with our investor protection mandate. Because registering with the PCAOB enables a firm to issue audit reports or play a substantial role on audits performed under PCAOB standards for issuers and broker-dealers, and because prospective clients and investors could reasonably expect that any firm that could pursue such an engagement would already have a PCAOB-compliant QC system designed and ready for implementation and operation, we believe that imposing a design requirement on all registered firms would promote our mission of protecting investors and promoting the public interest.

We are soliciting comment on the extent to which the requirements of QC 1000 should apply to firms that do not perform engagements.

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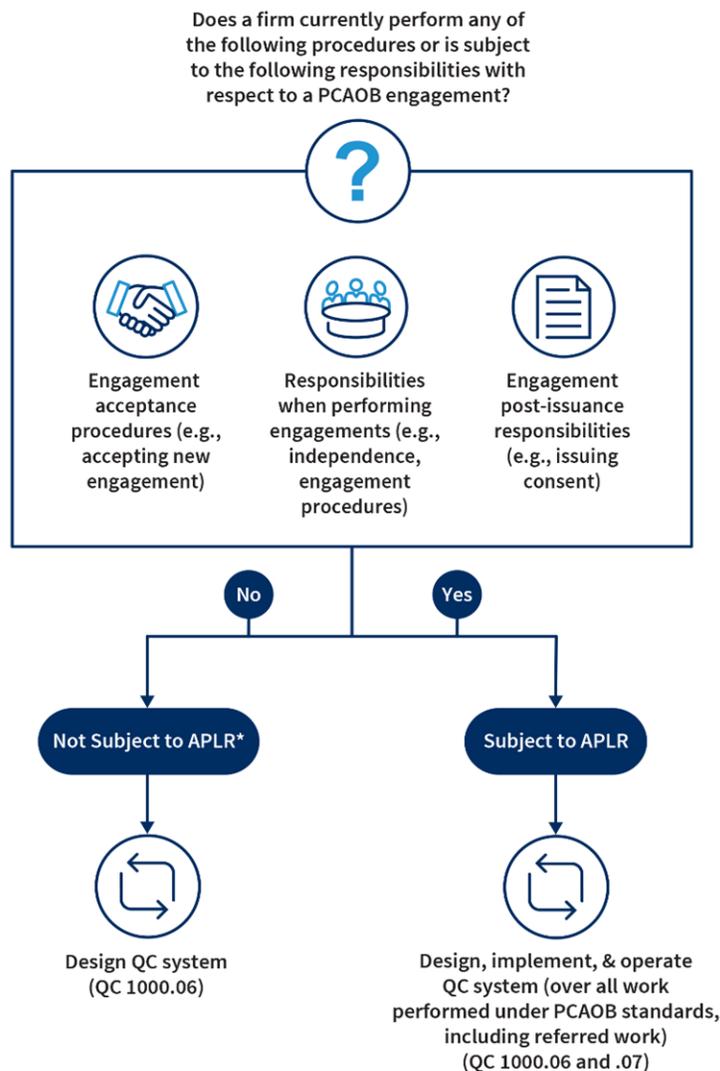
<sup>122</sup> Section 103(a)(2)(B) of Sarbanes-Oxley, 15 U.S.C. § 7213(a)(2)(B).

<sup>123</sup> Section 102(b)(2)(D) of Sarbanes-Oxley, 15 U.S.C. § 7212(b)(2)(D).

<sup>124</sup> Item 4.1 of PCAOB Form 1 (“Applicant’s Quality Control Policies”). We are also proposing to modify the information about QC required in Form 1. See Section V.C.8 below.

<sup>125</sup> See Frequently Asked Questions Regarding Registration with the Board, PCAOB Release No. 2003-011F (Dec. 4, 2017) (Question #32), *available at* [https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/registration/information/documents/registration\\_faq.pdf?sfvrsn=c50d7356\\_0](https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/registration/information/documents/registration_faq.pdf?sfvrsn=c50d7356_0).

### Decision Tree for Requirements of QC System



\*APLR – Applicable professional and legal requirements.

## 2. Other scalability considerations

In the concept release, we acknowledged that a wide variety of firms are subject to the PCAOB’s quality control standards and that, while the basic objectives of the QC system are the same across all firms, the policies and procedures necessary to achieve those objectives could vary significantly. We therefore solicited comment on the factors we should consider in developing a scalable QC standard.

Commenters, including firms, generally supported a risk-based and principles-based standard as critical to scalability, and suggested that we focus on factors like firm size and complexity, risks, and the nature of the firm's engagements. Some commenters suggested that not adding requirements beyond those in ISQM 1 would also support scalability, and that overly prescriptive requirements would hamper scalability. Several commenters suggested that a principles-based standard be accompanied by application guidance for firms to consider. One firm cautioned that too much scalability could result in different levels of quality and execution and potentially a false sense of protection for investors. One commenter generally supported scalability through a risk-based approach, but suggested prescriptive requirements related to human capital management due to its effect on audit quality. Another commenter suggested an extended implementation period to allow field testing for scalability.

We also solicited comment on whether there were aspects of the approach we were considering that would disproportionately affect smaller firms and, if so, how to mitigate those effects. A number of firms and a related group asserted that overly prescriptive requirements or incremental requirements beyond those reflected in ISQM 1 would disproportionately affect smaller firms, and that avoiding such requirements would assist small firms. Some identified particular areas that they considered likely to be problematic, including information and communication, monitoring and remediation, extending current SECPS requirements to all firms, required roles and responsibilities, requirements regarding training, requirements with respect to other audit participants, and documentation. Two professional associations suggested that smaller firms be exempted from all or portions of a new standard or that requirements be reduced to matters for consideration.

Proposed QC 1000 is risk-based, which makes it inherently scalable. Firms would apply a risk-based approach to the design, implementation, and operation of the QC system in the context of their own audit practice. The proposed standard provides that the firm should tailor the design of its QC system to its specific facts and circumstances, such as:

- The size and complexity of the firm;
- The types and variety of engagements it performs;
- The types of companies for which it performs engagements; and
- Whether it is a member of a network and, if so, the nature and extent of the network relationship.

The risk-based, scalable approach is reflected throughout proposed QC 1000, particularly in the risk assessment process and the monitoring and remediation process. The nature and extent of these processes would be commensurate with the firm's quality risks and would therefore vary across firms in nature, scope, and complexity. In addition, specific

provisions of the proposed standard would be scalable based on the nature and circumstances of the firm. For example:

- Depending on the nature and circumstances of the firm (including its size and structure), a single individual may be assigned more than one of the QC system oversight roles required under the proposed standard;
- Depending on the nature and circumstances of the firm, the process for identifying financial interests that may impair independence may need to be automated;
- Firms with a larger audit practice would be required to monitor in-process as well as completed engagements; and
- Firms would be required to consider their nature and circumstances when determining the form, content, and extent of documentation related to their QC systems.

Many commenters also stressed the importance of guidance directed at smaller firms, including providing examples or other application material. If we were to adopt a new QC standard, we would consider the potential need for implementation guidance, particularly for smaller firms. We pose a number of questions throughout the release regarding the need for further guidance, and we are interested in views on whether such guidance is needed for smaller firms in light of scalability concerns raised by commenters.

## Questions

1. Is the proposed definition of “applicable professional and legal requirements” appropriate? Are there elements that should be excluded, or other requirements that we should include? If so, what are they?
2. Is the proposed definition of “engagement” clear and appropriate? If not, why not? Should the definition be narrower (e.g., limited to engagements required to be performed under PCAOB standards) or broader? If so, how?
3. Are the proposed definitions of “firm personnel,” “other participants,” and “third-party providers” sufficiently clear and comprehensive, or is additional direction necessary? Please explain what additional direction may be necessary.
4. Is the other terminology used in QC 1000 clear and appropriate? Are there other terms that should be defined?
5. Is it appropriate for the proposed standard to require firms that have not and do not plan to perform engagements pursuant to PCAOB standards to design a QC system in accordance with QC 1000? Why or why not? Would this requirement impose disproportionate costs on small firms? Please provide data or estimates, if available, on such costs.

6. Is the proposed distinction between the obligation to design a QC system and the obligation to implement and operate a QC system appropriate? Is the proposed threshold for full applicability of QC 1000—having obligations under applicable professional and legal requirements with respect to a firm engagement—appropriate?
7. Is it clear how a firm’s responsibilities under QC 1000 may change depending on the extent of “applicable professional and legal requirements” to which the firm is subject at a particular time? Please explain what additional direction may be necessary.
8. Are there other provisions of QC 1000 that should apply to all firms? If so, which other provisions should we consider?
9. We intend the proposed standard to be scalable for all firms based on their nature and circumstances. Are there additional factors we should consider so that the proposed standard is scalable for all firms? If so, what are those factors? Should the standard be revised to make it more scalable? If so, how?

#### IV. PROPOSED QC 1000: A FIRM’S SYSTEM OF QUALITY CONTROL

This section describes the requirements of the proposed standard and highlights the key differences between the proposed standard and both our current QC standards and the QC standards of other standard setters. The proposed text of QC 1000 is presented in text boxes. Terms defined in Appendix A to proposed QC 1000, *Definitions*, are italicized throughout. For readability, footnotes to the proposed rule text have been omitted. For the full proposed text of QC 1000, including footnotes, please see Appendix 1.

##### A. Introduction

.01 This standard sets forth the requirements for a registered public accounting firm (“firm”) with respect to the design, implementation, and operation of a quality control (“QC”) system. This standard establishes a risk-based approach to the firm’s QC system such that the firm proactively manages the quality of *engagements* it performs. This risk-based approach includes establishing *quality objectives*, identifying and assessing *quality risks* to the achievement of the *quality objectives*, designing and implementing *quality responses* to address the *quality risks*, and monitoring the firm’s QC system.

.02 A QC system, as described by this standard, consists of components that are present, function, and operate together, not exclusively in a linear manner, enabling the consistent performance of *engagements* in accordance with *applicable professional and legal requirements*. A QC system is a continual and iterative process that is responsive to changes in the nature and circumstances of the firm and its *engagements* and to relevant information that the firm gathers through its monitoring activities and from other sources. The QC system reflects and reinforces the firm’s role in protecting the interests of investors and furthering

the public interest in the preparation of informative, accurate, and independent audit reports.

.03 This standard describes the following eight integrated components of a firm's QC system:

- a. The firm's risk assessment process;
- b. Governance and leadership;
- c. Ethics and independence;
- d. Acceptance and continuance of client relationships and specific *engagements*;
- e. *Engagement* performance;
- f. Resources;
- g. Information and communication; and
- h. The monitoring and remediation process.

Note: The components of the QC system interact with each other in a variety of ways. For example, the firm's risk assessment process applies to the components for which *quality objectives* are established. The monitoring and remediation process applies to all of the components of the QC system, including the monitoring and remediation component itself.

.04 In addition to the requirements relating to the components of the QC system, this standard includes requirements related to:

- a. Roles and responsibilities (*see paragraphs .11-.17*);
- b. Evaluation of and reporting on the QC system (*see paragraphs .77-.80*); and
- c. Documentation of the QC system (*see paragraphs .81-.86*).

The introduction section of the proposed standard sets up the structure for providing the standard's requirements. Paragraphs .01-.02 describe the risk-based approach to the firm's QC system and acknowledge the important role of the QC system—supporting consistent performance of engagements in accordance with applicable professional and legal requirements—in protecting investors and furthering the public interest in the preparation of

informative, accurate, and independent audit reports. Paragraph .03 introduces the eight components that constitute the QC system. Paragraph .04 includes references to the sections of the proposed standard where additional requirements are set out.

## B. The Firm’s QC System

### 1. Proposed QC 1000

#### a. Objective of the QC system

.05 An effective QC system provides a firm with reasonable assurance that:

a. The firm, *firm personnel*, and *other participants*:

(1) Conduct *engagements* in accordance with *applicable professional and legal requirements*; and

(2) Fulfill their other responsibilities that are part of or subject to the firm’s QC system in accordance with *applicable professional and legal requirements*; and

b. *Engagement* reports issued by the firm are in accordance with *applicable professional and legal requirements*

(hereinafter referred to as the “reasonable assurance objective”).

Note: Reasonable assurance is obtained when a firm’s QC system reduces to an appropriately low level the risk that the objectives set forth in a. and b. are not achieved. Although not absolute assurance, reasonable assurance is a high level of assurance.

The proposed “reasonable assurance objective”<sup>126</sup> of the firm’s QC system would be similar to the objective of the QC system under existing PCAOB standards, except that the current standard requires reasonable assurance as to compliance with applicable requirements and “the firm’s standards of quality” (i.e., the firm’s policies and procedures),<sup>127</sup> whereas the proposed reasonable assurance objective refers only to applicable requirements.

This change reflects the different role played by firm policies and procedures under our current QC standards compared to proposed QC 1000. Firm policies and procedures are the

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<sup>126</sup> See Section III.A.2 for a further discussion of reasonable assurance.

<sup>127</sup> QC 20.03; QC 20.17.

linchpin of current PCAOB QC standards: Most of our current QC standards simply require firms to establish, communicate, document, and monitor specified policies and procedures. Policies and procedures also play an important role under proposed QC 1000, but they would have a different context because of the significant differences in the way in which the proposed standard is structured.

Proposed QC 1000 is grounded in the firm's risk assessment process, whereby the firm's quality objectives and the risks to achieving them would be identified and addressed by the firm in an ongoing, structured fashion. This risk assessment process would drive how the firm develops and refines its policies and procedures; they would be "quality responses" designed and implemented to address quality risks. As such, policies and procedures would be a means to an end—addressing quality risks—rather than an end in themselves. Proposed QC 1000 would also provide more detailed requirements regarding the structure, scope, and functioning of the firm's QC system, particularly in the monitoring and remediation component, than our current QC standards.

This would not mean that firms' QC policies and procedures are no longer important. On the contrary, they would be critical to achieving quality objectives and the reasonable assurance objective. However, firms may no longer rely on simply promulgating policies and procedures as the central, and sometimes only, component of their QC system. Compliance with the QC standard ultimately would be based on whether the firm had met its quality objectives and the reasonable assurance objective—which would be driven by whether the firm's policies and procedures had in fact been effective in addressing quality risks—and on whether the firm had complied with the requirements of the standard in the design, implementation, and operation of the QC system.

The proposed reasonable assurance objective also reflects the view that the purpose of the QC system is to drive overall compliance with applicable requirements, and not necessarily to drive more narrow compliance with firm policies and procedures (which may be highly detailed, involving firm-specific tools and checklists and firm-specific criteria that go beyond applicable requirements).

In the concept release we asked whether the objective of the quality management system provided in ISQM 1, which is focused on compliance with applicable requirements, would be appropriate for a QC system under PCAOB standards. Most commenters, including firms and related groups, supported the focus on compliance. On the other hand, one investor advocate claimed that an objective based on compliance with requirements would set the bar too low compared to a standard like ISO 9001, one of whose underlying principles is that "[t]he primary focus of quality management is to meet customer requirements and strive to exceed

customer expectations.”<sup>128</sup> Another comment letter suggested that the QC system should have an explicit goal that audits be performed in a manner that protects the interests of investors and broker-dealer customers and furthers the public interest.

We considered a more general objective focused on “high-quality” engagements rather than compliance with applicable requirements. However, we do not believe that such an objective would be clearly understood or consistently interpreted, either across firms or over time, because there is no universal definition of what “audit quality” means beyond compliance with applicable requirements.<sup>129</sup> For example, audit quality cannot simply be inferred from financial reporting quality; an audit can be deficient even though the financial statements are not, and vice versa.<sup>130</sup> As a consequence, we believe making “quality” the objective would not provide sufficient notice of the applicable requirements, creating significant uncertainty for firms attempting to apply and comply with the standard.

As one commenter suggested, we also considered an objective similar to ISO 9001, under which firms would define their own quality objectives with the aim of enhancing the satisfaction of their “customers”—financial statement users—as well as complying with applicable professional and legal requirements. We believe such an approach would raise many of the same concerns as an objective based on “quality.” In fact, it could create further uncertainty and inconsistency as firms attempt to satisfy the specific preferences of the users of the financial statements they audit. We agree with the commenter that the needs of financial statement users are of paramount importance in the development of proposed QC 1000. However, we believe those needs can best be served by including in the proposed standard a clear, consistent objective that is grounded in auditors’ existing obligations—obligations that are themselves intended to address financial statement users’ central concern, that financial statements be free of material misstatement.

Under proposed QC 1000, the objective of the firm’s QC system is generally consistent with the objective in existing QC standards, but it places more emphasis in two key areas:

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<sup>128</sup> ISO 9000, Quality Management Systems—Fundamentals and Vocabulary (2015-09-15) at 2.3.1.1.

<sup>129</sup> The IAASB reached a similar conclusion. See ISQM 1, *Basis for Conclusions*, paragraph 24, available at <https://www.ifac.org/system/files/publications/files/IAASB-ISQM-1-Basis-for-Conclusions.pdf>.

<sup>130</sup> Comments on our 2015 Concept Release on the potential development and disclosure of key indicators of audit quality indicated a lack of context and a lack of consensus, among regulators, firms, and financial statement users, regarding specific metrics or measures that may be indicative of audit quality. See *Concept Release on Audit Quality Indicators*, PCAOB Release No. 2015-005 (July 1, 2015).

- Specifying that responsibilities be fulfilled not only with respect to professional standards, but also with respect to legal requirements to the extent they apply (e.g., SEC rules, other provisions of U.S. federal securities law, and other applicable legal and regulatory requirements); and
- Expressly mentioning engagement reporting (an existing responsibility under PCAOB standards), given the explicit reference to audit reports in Sarbanes-Oxley.<sup>131</sup>

Responsibilities in this context includes all responsibilities that are subject to applicable professional and legal requirements—for example, in relation to the firm’s engagements, work the firm does on other firms’ engagements, training, independence monitoring, and other activities that are part of or subject to the firm’s QC system.

In addition, the proposed objective would cover the activities of a broader group than current standards. It would apply not only with respect to firm personnel and other auditors, but also to other participants involved in the firm’s engagements and QC activities whose work is performed at the direction of the firm. As discussed in Section III.B above, we believe that the proposed standard should reach such other participants in light of, among other things, the increasing prevalence and importance of the use of professionals and organizations outside the firm, such as auditor-engaged specialists and service centers, in audits performed under PCAOB standards.

In the concept release, we also asked if there are other objectives, in addition to the reasonable assurance objective, that a firm’s QC system would need to achieve. The commenters who addressed this topic, comprised of firms and a related group, generally stated that no additional objectives were necessary.

.06 A firm must design a QC system that complies with this standard. To design such a QC system, the firm must:

- a. Assign QC-related roles and responsibilities (see paragraphs .11-.17);
- b. Establish *quality objectives*, annually identify and assess *quality risks* to those objectives, and design *quality responses* to those risks (see paragraphs .18-.57);
- c. Design a monitoring and remediation process (see paragraphs .58-.76); and
- d. Document the design of the QC system (see paragraphs .81-.86).

<sup>131</sup> See, e.g., Section 103(a)(1) of Sarbanes-Oxley, 15 U.S.C. § 7213(a)(1); Section 103(a)(2)(B) of Sarbanes-Oxley, 15 U.S.C. § 7213(a)(2)(B).

- .07 The requirement to implement and operate the QC system applies as follows:
- a. A firm must implement and operate an effective QC system at all times when the firm is required to comply with *applicable professional and legal requirements* with respect to any of the firm's *engagements*, and thereafter through the following November 30.
  - b. During the time the firm's QC system is required to be operating effectively, the firm's QC system must operate over any audit, attestation, review, or other work performed under PCAOB standards by the firm, regardless of the level of the firm's participation in such work (i.e., even if the firm plays less than a substantial role).
  - c. A firm that is required to implement and operate its QC system is also required to annually evaluate its QC system as of November 30 and report on that evaluation (see paragraphs .77-.80).
  - d. For any time that a firm is not required to implement and operate an effective QC system, this standard will apply to the firm only in regard to the design of the QC system (based on the *quality risks* the firm likely would face if it were to perform engagements) as provided in paragraph .06.

Note: Any obligations under QC 1000 that exist at the time a firm is no longer required to implement and operate the QC system, such as obligations to evaluate and report on the QC system for previous periods, will continue.

The proposed standard would require all firms to design a QC system that complies with this standard. This would entail assigning QC-related roles and responsibilities as provided in paragraphs .11-.17 of QC 1000; establishing quality objectives, at least annually identifying and assessing quality risks to those objectives, and designing quality responses to those risks, as provided in paragraphs .18-.57; designing a monitoring and remediation process that, upon implementation, would comply with paragraphs .58-.76; and documenting the design of the QC system as provided in paragraphs .81-.86. The design of the QC system would be based on the quality risks the firm likely would face if it performed engagements.

In addition to the obligation to design the QC system, firms would be required under paragraph .07 to implement and operate an effective QC system, (i.e., would be subject to all provisions of the proposed standard) at all times that the firm is required to comply with applicable professional and legal requirements with respect to any of the firm's

engagements.<sup>132</sup> This would include, for example, whenever the firm has responsibilities with respect to the acceptance of an engagement, the performance of an engagement, remediation of deficiencies in an engagement, or matters associated with an engagement that arise after issuance of the engagement report, such as reports included in Securities Act filings (including consent to the inclusion of such reports),<sup>133</sup> omitted audit procedures or other engagement deficiencies,<sup>134</sup> and subsequently discovered facts.<sup>135</sup> Once a firm no longer has any responsibilities under applicable professional and legal requirements with respect to any firm engagements, the firm would be required to continue operating the QC system until the next November 30 (the next date as of which the firm would be required to evaluate the QC system). This would ensure that the firm would be required to evaluate and report on the QC system for any year during which the QC system was required to operate.<sup>136</sup>

Note that firms may not have lengthy advance notice before responsibilities arise under applicable professional and legal requirements with respect to an engagement. For example, a firm may be contacted by an affiliated firm to play a substantial role in an engagement or may be asked to consent to the inclusion of a previously issued audit report in the registration statement of a former client. Under the proposed standard, registered firms would have to stand ready to have their QC system implemented and operating over such responsibilities whenever they arise.

Although all PCAOB-registered firms would have to design a QC system that complies with the proposed standard, the obligation to implement and operate that system would apply only when the firm was required to comply with applicable professional and legal requirements with respect to the firm's engagements. Implementing and operating a QC system means that assigned personnel are fulfilling their QC-related roles and responsibilities under QC 1000, the quality responses (i.e., policies and procedures) and monitoring and remediation process that the firm has designed are operational, and the firm is documenting the implementation and operation of its QC system. As noted above in the discussion of scalability, the scope of the QC system would be driven by the professional and legal requirements that apply to the firm and

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<sup>132</sup> Note, however, that the firm would not necessarily have to implement and operate every QC policy and procedure it has designed. See Section III.C, Scalability.

<sup>133</sup> See AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*.

<sup>134</sup> See AS 2901, *Consideration of Omitted Procedures After the Report Date*. We are proposing to amend AS 2901 in connection with this rulemaking to expand auditor responsibilities with respect to engagement deficiencies. See Part V.A for additional discussion.

<sup>135</sup> See AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

<sup>136</sup> The proposed requirements for evaluation and reporting on the QC system are discussed in Section IV.L below.

its engagements and the relevant risks, which could vary depending on the nature and extent of the firm's practice.

The proposed standard also makes clear that existing obligations under QC 1000, such as the obligation to evaluate and report on the QC system for periods in which the QC system was required to be implemented and operating, would not be extinguished if a firm were to transition from full applicability to scaled applicability. For example, if a firm resigned from its only issuer engagement seven years ago and had no other responsibilities with respect to that or any other engagement, the firm would still be required to evaluate and report on its QC system as of November 30 of that year.

As discussed in more detail in Part III.C above, our initial view is that requiring all registered firms to design a QC system that complies with the proposed standard would be consistent with our statutory mandate, historical practice, and investor protection mission, and that scaling back obligations under QC 1000 to the design of the QC system, as described under proposed paragraph .06, would be justified in cases where a firm is not subject to any obligations under applicable professional and legal standards with respect to any firm engagement.

#### **b. Risk-based approach**

- .08 In applying a risk-based approach to its QC system, the firm must:
- a. Design, implement, and operate a risk assessment process, including:
    - (1) Establishing *quality objectives* necessary to achieve the reasonable assurance objective;
    - (2) Identifying and assessing *quality risks* to the achievement of the *quality objectives*; and
    - (3) Designing and implementing *quality responses* to address the *quality risks*;
  - b. Design, implement, and operate a monitoring and remediation process; and
  - c. Evaluate the effectiveness of the QC system and report on that evaluation.
- .09 In applying a risk-based approach to the firm's QC system, the firm must take into account the nature and circumstances of the firm, its *engagements*, and other relevant information. Accordingly, the firm should tailor its QC system to the firm's specific facts and circumstances (e.g., the size and complexity of the firm, the types and variety of *engagements* it performs, the types of companies for which it performs *engagements*, and

whether it is a member of a network and, if so, the nature and extent of the relationship between the firm and the network).

Note: Networks may be structured in a variety of ways and could include arrangements between firms for the purpose of sharing knowledge; developing and implementing consistent policies, tools, and methodologies; conducting multi-location *engagements*; or executing other types of business or service matters. Networks may include both registered and non-registered accounting firms.

The proposed standard requires a firm to employ a risk-based approach to quality control, such that the firm proactively manages its QC system and the quality of the work it performs on engagements. Commenters, including firms and related groups, encouraged the Board to preserve the risk-based approach of ISQM 1 in a new PCAOB standard. For example, two groups representing firms suggested that such an approach would allow firms to tailor their QC systems to their particular facts and circumstances. One firm asserted that a risk-based approach would allow the standard to not only reflect the current auditing environment but also be adaptable to future changes within the auditing profession. Other firms suggested that a proactive risk-based approach would rely on a continuous improvement process supported by ongoing and periodic monitoring and remediation.

Under the proposed standard, the firm would be required to design, implement, and operate a QC system that reflects and responds to the firm's particular risks.

- The firm's risk assessment process—establishing quality objectives, identifying and assessing quality risks to the achievement of those objectives, and designing and implementing quality responses to the identified quality risks—would be applied to all of the aspects of the firm's organization and operations that are covered by the QC system and thus be tailored to each firm's specific facts and circumstances.
- The monitoring and remediation process would also be carried out in a way that is informed by and responsive to risks—for example, quality risks would influence both the selection of engagements to monitor and the design and extent of monitoring activities.

Furthermore, the requirement to evaluate the effectiveness of the QC system would support continued improvement in these risk assessment and monitoring and remediation processes by requiring the firm to evaluate and report on whether the quality objectives and the reasonable assurance objective have been achieved. These requirements are discussed in more detail in Section IV.D, Section IV.K, and Section IV.L below.

The fact that proposed QC 1000 is risk-based makes it inherently scalable. In applying a risk-based approach, the firm would be required to tailor its QC system to the firm's specific facts and circumstances, including the size and complexity of the firm, the types and variety of engagements it performs, the types of companies for which it performs engagements, and whether it is a member of a network and, if so, the nature and extent of the relationship between the firm and the network. Accordingly, a large, complex firm that performs a wide variety of engagements would likely be required to have a more complex QC system than a small firm that performs a small number of less complex engagements.

### c. Due professional care

.10 All *firm personnel* and *other participants* involved in the design, implementation, and operation of the QC system must exercise due professional care. Due professional care requires, among other things, the exercise of professional skepticism when obtaining and evaluating information. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the relevant information. *Firm personnel* and *other participants* must use the knowledge, skill, and ability called for by *applicable professional and legal requirements* to diligently perform, in good faith and with integrity, the obtaining and objective evaluation of information.

Paragraph .10 of the proposed standard addresses due professional care in performing responsibilities in relation to the QC system. In commenting on the concept release, one firm asserted that the concept of appropriate standards of conduct, including due professional care, is already required by existing PCAOB standards and would be duplicative in the proposed QC standard. We believe that this provision could be a helpful clarification because the existing PCAOB standards describing due professional care, AS 1015, *Due Professional Care in the Performance of Work*, and paragraphs .39-.41 of AT Section 101, *Attest Engagements*, do not specifically mention QC activities. The concept of due professional care imposes a responsibility upon firm personnel and other participants to observe relevant professional standards including, in the context of quality control, the proposed standard. The language of paragraph .10 and its accompanying footnote is adapted from the existing concept of due professional care in AS 1015 to fit the QC context.

## 2. Current PCAOB standards

As described in Section II.A above, under current QC standards, a QC system is broadly defined as a process to provide a firm with reasonable assurance that its personnel comply with professional standards applicable to its accounting and auditing practice and the firm's

standards of quality.<sup>137</sup> The QC system encompasses the firm’s organizational structure, policies adopted, and procedures established to provide that reasonable assurance.<sup>138</sup> Registered firms are required to design and implement a system of quality control to provide this reasonable assurance.

### 3. Key differences from other QC standards

As discussed earlier, under proposed QC 1000, the reasonable assurance objective of the firm’s QC system covers the activities of the firm, firm personnel, and other participants whereas the reasonable assurance of ISQM 1 and SQMS 1 cover activities of the firm and its personnel only. Section III.B above provides a discussion of our rationale for addressing other participants explicitly in the QC standard.

#### Questions

10. Is the reasonable assurance objective described in the proposed standard appropriate? If not, why not? Are there additional objectives that a QC system should achieve? If so, what are they?

11. Are the proposed requirements regarding design of the QC system appropriate? Are there other aspects of QC 1000 that should be required as part of the design of the QC system? If so, what are they?

### C. Roles and Responsibilities

Expectations of individuals within the QC system are established through the assignment of roles and responsibilities that are essential to a well-functioning QC system. This aspect of the QC system is intended to create clearer lines of communication and decision-making authority and greater accountability for those assigned to such roles.

#### 1. Proposed QC 1000

.11 The firm’s principal executive officer (i.e., the highest-ranking executive, regardless of formal title) is ultimately responsible and accountable for the QC system as a whole.

Note: If a firm has co-principal executive officers, the references to “the individual assigned ultimate responsibility and accountability for the QC system as a whole” apply to each of the co-principal executive officers and

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<sup>137</sup> See QC 20.03.

<sup>138</sup> See QC 20.04.

each of them is ultimately responsible and accountable for the QC system as a whole.

.12 The firm must assign other roles and responsibilities with respect to the QC system to *firm personnel* who have the experience, competence, authority, and time to enable them to carry out their assigned responsibilities. Such roles should include the following:

- a. Operational responsibility and accountability for the QC system as a whole;
- b. Operational responsibility for the firm's compliance with ethics and independence requirements;
- c. Operational responsibility for the monitoring and remediation process; and
- d. If appropriate based on the nature and circumstances of the firm, operational responsibility for other components of the QC system.

Note: Depending on the nature and circumstances of the firm (including its size and structure) and its *engagements*, the firm may assign one individual to more than one of the roles identified in paragraphs .11 and .12.

.13 The firm should establish a direct line of communication from each individual assigned operational responsibilities (*see* paragraph .12a.-d.) to the individual assigned ultimate responsibility and accountability for the QC system as a whole (*see* paragraph .11).

We propose to require the highest-ranking executive in the firm to bear ultimate responsibility and accountability for the QC system as a whole. If a firm has co-principal executive officers, each of them would bear such ultimate responsibility and accountability. We are not proposing to prescribe the substantive qualifications the highest-ranking executive in the firm should have, so the provision does not include any such criteria (unlike the assigned roles under paragraph .12, which only may be assigned to personnel who have the experience, competence, authority, and time to carry out their responsibilities). Our intention is to establish accountability for QC at the highest level within the firm and underscore the critical importance of the QC system. Accordingly, we do not believe that the ultimate responsibility can be delegated to subordinates.

The requirement in paragraph .12 of proposed QC 1000 is principles-based. It is limited to roles that are expected to exist in any firm and allows each firm to assign these roles based on the nature and circumstances of the firm, provided that those assigned have the experience, competence, authority, and time to enable them to carry out their assigned responsibilities. This approach also addresses scalability concerns raised by some commenters; as the note to

paragraph .12 makes clear, depending on the nature and circumstances of the firm, one individual may be assigned to more than one of the roles in paragraphs .11 and .12. For the roles specified in paragraph .12, only one individual may be assigned responsibility for each role. A firm may have multiple individuals or multiple layers of personnel supporting these roles, but the responsibility for the assigned role may not be delegated and would remain with the one assigned individual.

Provided that the criteria in paragraph .12 of proposed QC 1000 are met, the individual assigned ultimate responsibility and accountability for the QC system also may assume responsibility for all aspects of the QC system, including operational responsibility for the QC system, the firm's compliance with ethics and independence requirements, and the monitoring and remediation process.

There may be multiple levels of leadership within the firm's organizational structure. Under such circumstances, an individual assigned a required role within the QC system may seek assistance from others in performing certain tasks in fulfilling their responsibilities. Regardless of whether specific tasks are delegated to others, the individual assigned to a specified role remains responsible and accountable for the role's related responsibilities. The firm could also assign roles in addition to those specified in paragraph .12, such as operational responsibility for managing a service line or a geographic area.

The concept release discussed specifying roles and responsibilities of firm personnel in relation to the firm's QC system. It also asked if the roles (ultimate responsibility and accountability for the QC system, operational responsibility for the QC system as a whole, operational responsibility for independence quality controls, and operational responsibility for monitoring and remediation) and responsibilities discussed in the concept release were appropriate, or if other roles or responsibilities should be added. Several commenters, including firms, said it was appropriate to specify the roles and responsibilities for the QC system and the majority of these commenters supported the roles and responsibilities described. One firm supported specifying responsibilities, but expressed concern that specifying roles may limit flexibility as to who should perform such responsibilities. Some firms and a related group supported only specifying the role and related responsibilities for the person with operational responsibility for independence quality controls due to the complexity and importance of independence rules. Some firms and related groups were not supportive of including specific roles and responsibilities in the standard, citing concerns about scalability or the benefits of providing flexibility to firms. Some commenters were supportive of adding other roles or responsibilities to the standard. Other commenters stated that no other roles or responsibilities should be added.

Our current view is that the roles specified in paragraph .12 would be appropriate for every firm. The proposal would also provide firms the ability to add additional roles and responsibilities, if appropriate, and the flexibility to assign one individual to more than one of

the roles specified. We believe these requirements would support scalability, as suggested by commenters.

We discuss each of the QC roles identified in the proposed standard in the subsections that follow. Paragraph .13 provides that individuals assigned operational responsibilities under paragraph .12 should have a direct line of communication to the individual with ultimate responsibility and accountability for the QC system. This line of communication would provide these individuals the information necessary to perform their assigned roles.

**a. Ultimate responsibility and accountability for the QC system as a whole**

.14 The individual assigned ultimate responsibility and accountability for the QC system as a whole should:

- a. Demonstrate a commitment to quality through the individual's actions, behaviors, and communications. This includes recognizing and reinforcing the importance of professional ethics, values, and attitudes, and establishing the expected behavior of *firm personnel* related to activities within the firm's QC system and the performance of its *engagements*.
- b. Establish or direct the establishment of structures, reporting lines, and authorities and responsibilities for the following roles:
  - (1) Operational responsibility and accountability for the QC system as a whole;
  - (2) Operational responsibility for the firm's compliance with ethics and independence requirements;
  - (3) Operational responsibility for the monitoring and remediation process; and
  - (4) If assigned, operational responsibility for other aspects of the QC system.
- c. Be accountable for the design, implementation, and operation of the firm's QC system in accordance with *applicable professional and legal requirements* and the firm's policies and procedures and for the annual evaluation of the firm's QC system required by paragraph .77.
- d. Certify the firm's report to the PCAOB on its annual evaluation of the QC system (*see* paragraph .79).

The individual assigned ultimate responsibility and accountability for the QC system as a whole reinforces the responsibility and accountability of firm personnel by demonstrating a

commitment to quality. The proposed standard would emphasize the role of that individual—by the individual recognizing and reinforcing professional ethics, values, and attitudes through the individual’s actions, behaviors, and communications—in establishing a firm’s tone at the top and attitude towards quality.

Additionally, the individual assigned ultimate responsibility and accountability would be responsible for establishing, or directing the establishment of, structures, reporting lines, and authorities and responsibilities for the roles involving operational responsibility for aspects of the QC system and the QC system as a whole. For each firm, the approach to fulfilling these responsibilities would be dependent on the firm’s nature and circumstances. For example, in a smaller firm where there are fewer individuals with assigned roles, structures and reporting lines may be less formal. Conversely, for a larger firm, it may be necessary to have multiple individuals in roles with assigned responsibilities or to have multiple layers of personnel supporting different activities. However, ultimate responsibility and accountability cannot be delegated.

Also, the individual assigned ultimate responsibility and accountability would be accountable for the design, implementation, and operation of the firm’s QC system in accordance with applicable professional and legal requirements and the firm’s policies and procedures, as well as for the firm’s annual QC system evaluation. The functions performed by the individual with ultimate responsibility and accountability would likely vary across firms. For example, in a smaller firm, the individual assigned ultimate responsibility and accountability may be directly involved in aspects of the QC system, such as the firm’s monitoring and remediation process. In a larger firm, this person may supervise others who perform these activities.

Lastly, we are proposing requiring the individual assigned ultimate responsibility and accountability for the QC system as a whole, along with the individual assigned operational responsibility and accountability for the firm’s QC system as a whole, to certify the firm’s annual evaluation of its QC system in a report to the PCAOB. As we discuss further in Section IV.L.1.c.iii below, we believe such certification would lead to increased discipline in the evaluation process and would reinforce the accountability of the certifying individuals.

**b. Operational responsibility and accountability for the QC system as a whole**

.15 The individual assigned operational responsibility and accountability for the QC system as a whole should:

- a. Supervise the design, implementation, and operation of the firm’s QC system in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures; and

- b. Certify the firm's report to the PCAOB on its annual evaluation of the QC system (see paragraph .79).

The individual assigned operational responsibility and accountability for the QC system as a whole would be accountable for supervising the design, implementation, and operation of the firm's QC system. This would include overseeing the operation of the QC system in achieving the reasonable assurance objective. Depending on the nature and circumstances of the firm, this individual may be the same person assigned ultimate responsibility and accountability for the QC system, or may be assigned other operational responsibilities, such as for ethics and independence or monitoring and remediation.

In carrying out the specified responsibilities, the individual assigned operational responsibility and accountability for the QC system as a whole would be supported by the individuals assigned operational responsibility for the firm's compliance with ethics and independence requirements, the monitoring and remediation process, or other components of the QC system. This would include receiving information from such individuals regarding violations of ethics and independence requirements and the results of the monitoring and remediation process.

Along with the individual assigned ultimate responsibility and accountability for the QC system as a whole, and for similar reasons, we are proposing to require the individual assigned operational responsibility and accountability for the QC system as a whole to certify the firm's annual report to the PCAOB on the evaluation of its QC system, as discussed in Section IV.L.1.c.iii below.<sup>139</sup>

**c. Operational responsibility for the firm's compliance with ethics and independence requirements**

.16 The individual assigned operational responsibility for the firm's compliance with ethics and independence requirements should:

- a. Supervise the design, implementation, and operation of the firm's ethics and independence component (see paragraphs .30-.36); and
- b. Communicate, on a timely basis, violations of ethics or independence requirements, including personal independence violations, to the individuals assigned (1) operational responsibility for the firm's monitoring and remediation

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<sup>139</sup> If the same person were assigned both ultimate responsibility and accountability and operational responsibility and accountability for the QC system, that person would sign the certification in both capacities.

process and (2) operational responsibility and accountability for the QC system as a whole.

Compliance with ethics and independence requirements is essential to the performance of engagements and, in some situations, presents challenging, novel, or complex issues. Our current requirements for former SECPS member firms include designating a senior-level partner to oversee the firm's independence policies and consultation process, among other independence-related activities. The concept release discussed retaining these requirements and extending them to all firms. The proposed standard contemplates that the individual assigned operational responsibility for compliance with ethics and independence requirements would supervise the areas addressed by the ethics and independence component in the proposed standard, which include the firm's risk assessment process for ethics and independence and the design, implementation, and maintenance of the firm's policies and procedures related to ethics and independence.

Within the ethics and independence component of the proposed standard, there are quality objectives and specified quality responses that address potential violations of ethics and independence requirements, including a quality objective that potential violations are communicated to the individual with operational responsibility for ethics and independence requirements. That individual would then be responsible for communicating such violations to the individuals assigned operational responsibility for the monitoring and remediation process and operational responsibility and accountability for the QC system as a whole. These communications are intended to enable these individuals to take timely and appropriate actions in accordance with their responsibilities.

**d. Operational responsibility for the monitoring and remediation process**

.17 The individual assigned operational responsibility for the monitoring and remediation process should:

- a. Supervise the design, implementation, and operation of the firm's monitoring and remediation process (see paragraphs .58-.76) and the annual evaluation of the QC system (see paragraphs .77-.78), including:
  - (1) The evaluation of the results of the monitoring activities;
  - (2) The evaluation of whether remedial actions are implemented as designed and operate effectively to remediate *QC deficiencies* and, if not, the taking of timely action until such *QC deficiencies* are remediated; and

(3) The firm's other policies and procedures with regard to monitoring and remediation.

b. Communicate, on a timely basis, to the individuals assigned (1) ultimate responsibility and accountability for the QC system as a whole and (2) operational responsibility and accountability for the QC system as a whole, a description of:

(1) Monitoring activities performed and the results of such activities, including, if applicable, monitoring activities performed by the network;

(2) Identified *engagement deficiencies*, *QC deficiencies*, and *major QC deficiencies*, including the nature, severity, and pervasiveness of such deficiencies; and

(3) Actions taken to address *engagement deficiencies*, *QC deficiencies*, and *major QC deficiencies*.

The monitoring and remediation process is a critical part of a firm's QC system because it creates a feedback loop to inform the firm's risk assessment process and results in an approach that drives continuous improvement. The individual assigned operational responsibility for the monitoring and remediation process would be responsible for supervising the design, implementation, and operation of the monitoring and remediation process component and the evaluation of the QC system. This individual would also be responsible for overseeing actions taken to respond to identified engagement deficiencies, QC deficiencies, and major QC deficiencies.

In addition, the individual assigned operational responsibility for the monitoring and remediation process would be responsible for communicating, on a timely basis, matters related to monitoring and remediation to the individuals assigned ultimate responsibility and accountability for the QC system as a whole and operational responsibility and accountability for the QC system as a whole. These communications would include key aspects of the monitoring and remediation process, such as the monitoring activities performed, results of the monitoring activities, and the remedial actions taken. The communication of this information to the individual assigned ultimate responsibility and accountability for the QC system as a whole would facilitate and support that individual's overall accountability for the evaluation of the QC system.

## 2. Current PCAOB standards

QC 20.22 requires the assignment of responsibility for the design and maintenance of QC policies and procedures to appropriate individuals but does not specify the role or roles to

which such responsibilities should be assigned. In addition, members of the SECPS are required to designate a senior-level partner responsible for, among other things:

- Overseeing the functioning of the firm’s independence policies and consultation process;
- Maintaining the restricted entity list and providing it to all professionals; and
- Supervising the monitoring system related to overseeing that independence violations are addressed.

Proposed QC 1000 retains and expands on these concepts. However, rather than specifying that a senior-level partner be responsible for independence matters, the proposed standard takes a more functional approach, requiring a person with the experience, competence, authority, and time to enable them to carry out the assigned responsibilities.

Another key difference is that QC 1000 would impose specific responsibilities on the individuals assigned the specified roles, such that enforcement action could be brought against them individually if they fail to meet those responsibilities. Current QC standards generally impose responsibilities directly on the firm rather than on individuals. Enforcement actions related to the failure to comply with current QC standards can be brought against individuals for knowingly or recklessly contributing to violations by the firm<sup>140</sup> or for the failure reasonably to supervise an associated person of the firm who commits certain violations.<sup>141</sup> Under proposed QC 1000, the individuals who are assigned specific responsibilities with respect to the QC system could be charged with violations if they fail to comply with those responsibilities, as well as for knowingly or recklessly contributing to firm violations or failing reasonably to supervise. We believe that providing another basis for enforcement against responsible individuals could enhance their accountability for the QC system.

### **3. Key differences from other QC standards**

Proposed QC 1000 requires that the specified roles and responsibilities with respect to the QC system be assigned to firm personnel. Proposed QC 1000 includes a certification requirement for the firm’s evaluation of the QC system.

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<sup>140</sup> See PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*.

<sup>141</sup> See Sarbanes-Oxley § 105(c)(6); 15 U.S.C. § 7215(c)(6).

## Questions

12. Are the proposed requirements related to roles and responsibilities described in the standard clear and appropriate? If not, how should they be clarified or modified?
13. Would firms have difficulty filling the specified roles in light of the proposed requirements?

### D. The Firm's Risk Assessment Process

The risk assessment process is the basis for a risk-based approach to the design, implementation, and operation of the firm's QC system. The firm's risk assessment process, in combination with the monitoring and remediation process, is intended to create a feedback loop to drive continuous improvement of the firm's QC system.

The proposed risk assessment process is principles-based and could be tailored to the size and complexity of the firm and the types and variety of engagements it performs. For example, for smaller and less complex firms, the risk assessment process may be centralized and involve only a few individuals. For larger and more complex firms, the risk assessment process may be more structured and decentralized, involving multiple layers and groups. The risk assessment process is also intended to be iterative and ongoing, so that new or developing risks would be identified and addressed as they emerge. We believe that the proposed risk-assessment approach would prompt firms to proactively identify, assess, and respond to quality risks, while at the same time allowing them to apply judgment when identifying and assessing quality risks. Commenters, including firms and related groups, agreed that principles-based requirements would be sufficient to prompt firms to appropriately identify, assess, and respond to risks.

We understand that some firms already employ risk assessment processes in their QC systems or have begun implementing them. The proposed risk assessment process should be familiar to firms because it is analogous to existing auditor responsibilities for identifying, assessing, and responding to risks of material misstatement of the financial statements. Audit procedures for identifying and assessing risks of material misstatement include information-gathering procedures to identify risks (e.g., obtaining an understanding of the company, its environment, and its internal control), assessment of risks based on information obtained, and design and implementation of responses to address the identified risks.<sup>142</sup> The proposed standard would create analogous responsibilities in relation to the QC system. Similarly, as the auditor is required, by auditing standards, to modify the overall audit strategy and the audit plan if circumstances change during the course of the audit,<sup>143</sup> the firm would be required, by

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<sup>142</sup> See generally AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

<sup>143</sup> See AS 2110.74.

the proposed QC standard, to monitor, identify, assess, and respond to changes in relevant conditions, events, and activities that affect the firm's QC system.

### 1. Proposed QC 1000

.18 The firm's risk assessment process provides the basis for the design, implementation, and operation of the firm's QC system. The risk assessment process consists of establishing *quality objectives*, identifying and assessing *quality risks* to the achievement of the *quality objectives*, and designing and implementing *quality responses* to the *quality risks*.

The firm's risk assessment process would be applied to the six components of the firm's QC system that have required quality objectives. To design, implement, and operate this process, the firm would be required to:

- Establish quality objectives;
- Identify and assess quality risks to the achievement of the quality objectives; and
- Design and implement quality responses to the identified quality risks.

The process for establishing quality objectives, identifying and assessing quality risks, and designing and implementing quality responses is iterative, and the requirements of the proposed standard would generally be addressed in a non-linear manner. For example, in identifying and assessing quality risks, the firm may determine that one or more additional quality objectives are required; in designing and implementing quality responses, the firm may identify additional quality risks.

#### a. Establish quality objectives

.19 The firm must establish the *quality objectives* necessary to achieve the reasonable assurance objective. This consists of the *quality objectives* specified in this standard and any other *quality objectives* that are necessary under paragraph .08a.(1).

Note: *Quality objectives* are specified in this standard for six of the components of the QC system: governance and leadership (see paragraph .25), ethics and independence (see paragraph .31), acceptance and continuance of client relationships and specific *engagements* (see paragraph .38), *engagement* performance (see paragraph .42), resources (see paragraph .44), and information and communication (see paragraph .53).

The proposed standard defines quality objectives as the desired outcomes to be achieved by the firm in relation to the components of the QC system. Establishing quality objectives is the first step in the risk assessment process and forms the basis for the identification and assessment of quality risks and the design and implementation of quality responses. The quality objectives are outcome-based and the risk assessment process provides firms the ability to determine how the quality objectives are to be achieved.

Quality objectives are specified in the proposed standard for six of the components of the QC system: governance and leadership, ethics and independence, acceptance and continuance of client relationships or specific engagements, engagement performance, resources, and information and communication. A firm could determine that it is necessary to establish quality objectives for its monitoring and remediation process. In those circumstances, the firm's risk assessment process would also apply to the monitoring and remediation process. Otherwise, although monitoring and remediation would not be subject to the firm's risk assessment process as described in the proposed standard, it would nevertheless be carried out in a way that is informed by and responsive to quality risks.<sup>144</sup>

We believe that, for many firms, the quality objectives specified in the proposed standard would likely be comprehensive and we do not expect, in the current environment, that additional quality objectives would generally be necessary. However, we also recognize that the nature and circumstances of a firm and its engagements will vary and conditions may change. Accordingly, a firm would be required to establish additional quality objectives if necessary to achieve the reasonable assurance objective.

The requirement for the firm to establish quality objectives necessary to achieve the reasonable assurance objective is designed to prompt ongoing reexamination of the quality objectives and modification as needed, which should enable the firm's QC system to adapt to a changing environment and remain fit for purpose. If a firm determines that its quality objectives need to be more specific, it could establish sub-objectives to provide a more direct link to quality risks and support the development of more comprehensive or better-targeted responses.

#### **b. Identify and assess quality risks**

.20 Annually, the firm must identify and assess *quality risks* to achieving each of the *quality objectives* established by the firm. The firm should:

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<sup>144</sup> See Section IV.K, Monitoring and Remediation Process below. For example, quality risks and the reasons for their assessment are factors a firm would take into account when determining the nature, timing, and extent of its monitoring activities.

The proposed standard defines quality risks as risks that, individually or in combination with other risks, have a reasonable possibility of adversely affecting the firm's achievement of one or more quality objectives if the risks were to occur, and are either (i) risks that have a reasonable possibility of occurring or (ii) risks of intentional acts by firm personnel and other participants to deceive or to violate applicable professional and legal requirements. The "reasonable possibility" term in the proposed definition of quality risks is aligned with use of the term in PCAOB standards:<sup>145</sup> there is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification ("FASB ASC") Topic 450, *Contingencies*.<sup>146</sup>

Additionally, we believe that firms should be thinking about risks of intentional misconduct in their risk assessment process, regardless of the assessment of probability of occurrence. We are concerned that, without an explicit prompt, firms may discount the possibility that intentional misconduct may occur and omit or underweight these types of risks in their risk assessment process. Therefore, under the proposed definition, for risks of intentional misconduct, the firm would only consider the likelihood that the risks would have an adverse effect on the achievement of its quality objectives. For all other risks, the firm would also assess the probability of occurrence in addition to assessing the probability of an adverse effect.

The proposed standard would require the firm to identify and assess quality risks for each quality objective it establishes. Most quality objectives are likely to have multiple quality risks. Some quality risks may relate to multiple quality objectives, either within a single component or across several components.

Effective risk assessment procedures involve identifying and assessing quality risks to the achievement of the quality objectives that are reflective of the nature and circumstances of the firm and its engagements. The proposed standard provides further direction regarding identification and assessment of quality risks, such as the firm questioning "what could go wrong" within the firm and its engagements that could adversely affect the firm's ability to achieve the quality objectives.

The proposed standard would require the identification and assessment of quality risks annually. Requiring an assessment annually, as well as when matters come to the firm's attention, is intended to result in a systematic, disciplined, and proactive approach to assessing the firm's quality risks. Through our oversight activities, we have observed that many firms update their QC systems on an ad hoc basis, in response to changes in regulatory requirements or deficiencies identified by internal or external inspections, and do not have a systematic

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<sup>145</sup> See generally, e.g., AS 1105, *Audit Evidence*; AS 2101, *Audit Planning*; AS 2201.

<sup>146</sup> See FASB ASC paragraph 450-20-25-1; see also, e.g., footnote 4 to AS 1105.12, which incorporates the ASC definition.

process of risk assessment. This reactive approach can result in firms taking corrective actions only after deficient audits have been identified. The proposed annual identification and assessment requirement would instill a regular and disciplined approach to performing a risk assessment annually and to identifying new quality risks that require modifications to the firm's quality responses or quality risks identified in a prior year that may no longer be sufficient or relevant.

The concept release asked whether the QC standard should specify certain quality risks. Commenters were generally not supportive of specifying quality risks in the standard. Some stated that such an approach would be too prescriptive or contrary to a risk-based approach, or could facilitate a "checklist" mentality. Others asserted that quality risks may evolve over time and may vary in their applicability across firms, and suggested that providing examples of types of quality risks or including factors for firms to consider in identifying and assessing quality risks would be more helpful.

The proposed standard does not specify quality risks that must be assessed and responded to by all firms; rather it includes factors for the firm to consider in its risk assessment process. We believe that such an approach would result in the firm identifying and assessing the quality risks that are most relevant in light of its facts and circumstances.

i. Obtain an understanding of the conditions, events, and activities that may adversely affect the achievement of the firm's quality objectives

a. Obtain an understanding of the conditions, events, and activities that may adversely affect the achievement of its *quality objectives*, which includes an understanding of the following:

(1) The nature and circumstances of the firm, including:

[Subparagraphs (a)-(i) to paragraph .20 are discussed below (see Appendix B for specific examples)]

(2) The nature and circumstances of the firm's *engagements* (see Appendix B for specific examples).

(3) Other relevant information, including information from the firm's monitoring and remediation activities, external inspections or reviews, and other oversight activities by regulators.

Note: The firm might identify conditions, events, and activities that may adversely affect the achievement of its *quality objectives* by asking "what

could go wrong?" in relation to the achievement of a given *quality objective*.

The proposed standard would require the firm, as part of identifying and assessing quality risks, to obtain an understanding of the conditions, events, and activities that may adversely affect the achievement of the firm's quality objectives. This understanding would underpin the firm's identification and assessment of the quality risks that are most relevant to the achievement of the firm's quality objectives. Appendix B of the proposed standard provides examples related to the nature and circumstances of the firm and its engagements that may give rise to quality risks.

The list in paragraph .20a. is not intended to be exhaustive, and the specific examples provided in Appendix B are meant to be illustrative rather than a checklist for every firm to consider. Whether particular conditions, events, and activities are relevant, and result in one or more quality risks, will depend upon the nature and circumstances of the firm and its engagements and how the conditions, events, and activities relate to or affect the operation of the firm's QC system and the performance of its engagements. The firm may also identify quality risks that do not relate to the list in paragraph .20a. or the specific examples.

The considerations highlighted in paragraph .20a. and Appendix B could assist the firm in identifying one or more quality risks to the achievement of one or more quality objectives. For example, consideration of changes in a firm's structure may be relevant for a firm that has recently completed an acquisition of another firm. This consideration may result in the identification of a number of quality risks, such as a quality risk that the audit methodology used by the acquired firm may not be compatible with the acquirer's methodology or a quality risk that the firm is unable to retain personnel post-acquisition, which may pose risks to quality objectives in areas like engagement performance and resources.

1) *The nature and circumstances of the firm*

The proposed standard includes a list of considerations related to the nature and circumstances of the firm. The accompanying description in italics appears in Appendix B of the proposed standard, which also provides specific examples of each consideration in paragraphs .B2 through .B10.

(a) *The complexity and operating characteristics of the firm;*

*This includes the size of the firm, the geographical distribution of the firm's operations, how the firm is structured, and the extent to which the firm concentrates or centralizes its processes or activities.*

- (b) The firm's business processes and strategic and operational decisions and actions;

*This includes decisions about financial and operational matters, including the firm's strategic goals.*

- (c) The characteristics and management style of leadership;

*This factor includes the composition of firm leadership, leadership tenure, distribution of authority among leadership, and how leadership motivates and encourages firm personnel.*

- (d) The resources of the firm;

*This includes people, financial, technological, and intellectual resources and the characteristics and availability of such resources.*

- (e) The environment in which the firm operates, including *applicable professional and legal requirements*;

*This includes economic stability; social and technological factors; laws and regulations directly relevant to the firm; and applicable professional and legal requirements affecting engagements performed by the firm.*

- (f) If the firm belongs to a network, the characteristics of the network and the network's resources and services and the nature and extent of such resources and services used by the firm;

*This includes the nature of the network, the nature and extent of the requirements established by the network, and the resources and services provided by the network.*

- (g) If the firm uses *other participants*, the nature and extent of their involvement;

*This includes the types of and extent to which the firm uses other participants and the characteristics of such other participants.*

- (h) If the firm participates in other firms' *engagements*, the nature and extent of the firm's participation; and

*This includes the nature of the procedures performed, the extent of participation, and other characteristics, including characteristics of the other firms.*

- (i) If the firm uses resources or services obtained from *third-party providers*, the nature and extent of those resources or services.

*This includes the types of and extent to which the firm uses third-party providers and the characteristics of such third-party providers.*

## 2) The nature and circumstances of the firm's engagements

In obtaining an understanding of the nature and circumstances of the firm's engagements, the firm would consider the types of engagements performed by the firm as well as the types of entities for which such engagements are undertaken. Paragraph .B11 of Appendix B of the proposed standard contains a list of examples of these considerations. For instance, a firm that conducts audits of brokers-dealers may consider information from relevant authorities, like the SEC and Financial Industry Regulatory Authority ("FINRA"), in identifying risks associated with such audit engagements.

## 3) Other relevant information

Other relevant information is intended to capture other information sources that help the firm to identify quality risks. One such source is from the firm's monitoring and remediation activities. Consideration of information from those activities would create a feedback loop within the QC system by informing the firm of the results of the monitoring and remediation process that may help the firm identify quality risks.

Another source is external inspections and oversight activities by regulators, and other external reviews, such as peer reviews. For example, the results of an external inspection may identify a high rate of noncompliance with independence requirements, which the firm would take into account when identifying and assessing quality risks for the ethics and independence component.

### ii. Identify and assess quality risks based on the understanding obtained

- b. Identify and assess *quality risks* based on the understanding obtained pursuant to paragraph .20a. and taking into account whether, how, and the degree to which the achievement of the *quality objectives* may be adversely affected.

Note: The assessment of *quality risks* is based on inherent risk (i.e., without regard to the effect of any related *quality responses*).

Under the proposed standard, identifying and assessing quality risks would be an ongoing, iterative process. The firm would assess risks as part of the initial design and implementation of the QC system, and thereafter annually, including in response to new information or changes in its circumstances and environment.

The proposed standard would require the firm to identify and assess quality risks for each of the quality objectives established by the firm, based on the understanding of the relevant factors and other relevant information and taking into account whether, how, and the degree to which the achievement of the quality objectives may be adversely affected. The note would clarify that this assessment is based on inherent risk, without regard to the effect of any related quality responses. The assessment is similar to the determination made under AS 2201 as to whether an account or disclosure is significant based on inherent risk, without regard to the effect of controls.<sup>147</sup>

Quality risks may affect one or more quality objectives, either within a single component or across several components. For example, a quality risk that the firm may not be able to attract and retain qualified personnel would affect several quality objectives in the resources component, and may also affect quality objectives in other components, such as engagement performance.

Under the proposed definition of quality risks, the firm would not be required to identify every conceivable risk, but only those that have a reasonable possibility of adversely affecting one or more quality objectives if they did occur, and either have a reasonable possibility of occurring or are risks of intentional misconduct by firm personnel or other participants. Limiting risks of intentional misconduct to only those that have a reasonable possibility of adversely affecting achievement of the firm's quality objectives would result in the firm concentrating its efforts on more pervasive and larger risks and not on every conceivable act of misconduct.

The identification of quality risks takes into account individual risks as well as combinations of risks. For example, a risk that has a reasonable possibility of occurring but individually does not have a reasonable possibility of adversely affecting the achievement of the quality objective may meet the proposed definition of a quality risk when analyzed in combination with other risks.

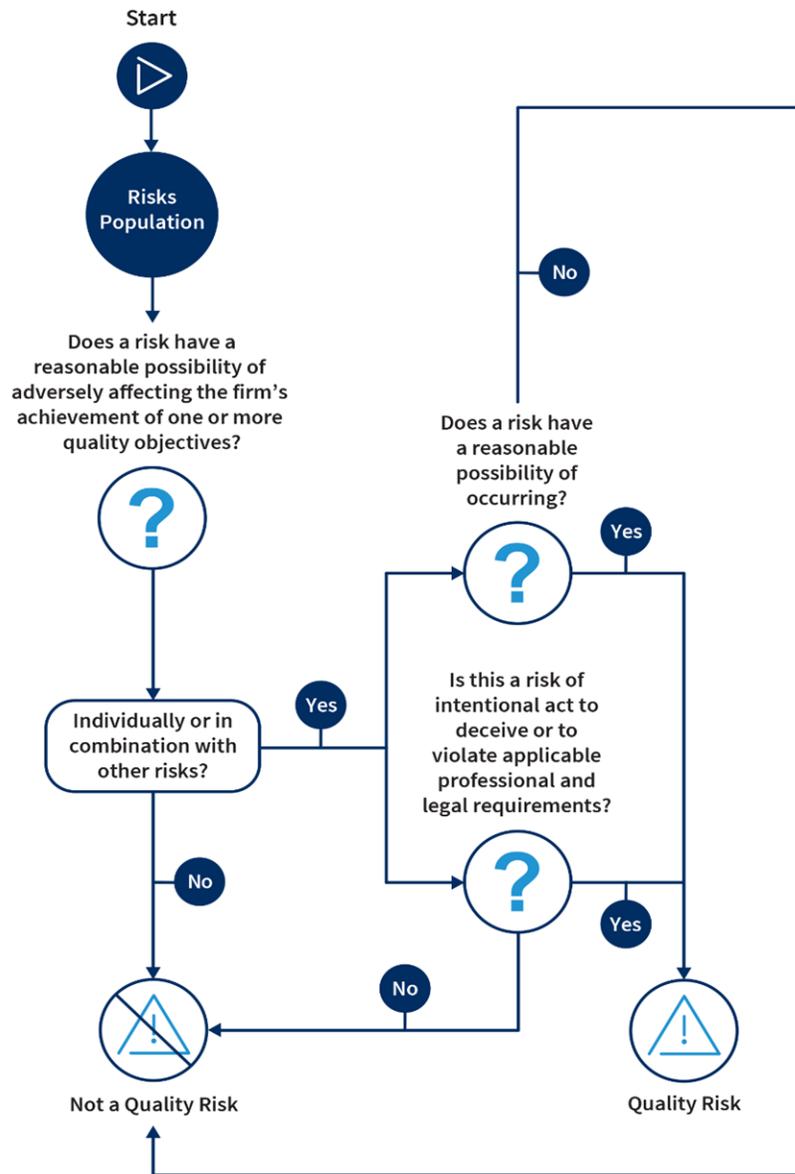
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<sup>147</sup> See AS 2201.A10.

The firm may undertake the quality risk assessment separately or concurrently with risk identification. The assessment of quality risks would be based on inherent risk (i.e., without regard to the effect of any related quality responses). Assessing the identified quality risks involves consideration of the frequency with which the quality risks may occur and the magnitude of the impact of the quality risks on the related quality objective(s). Identifying quality risks with the appropriate degree of specificity (not too narrowly or too broadly) would help the firm design quality responses that reduce to an appropriately low level the risk that the quality objective will not be achieved. Quality risks that are defined too broadly may result in quality responses that are not sufficiently targeted to the actual quality risk. Conversely, if quality risks are defined too narrowly, the quality responses may not sufficiently address the full extent of the quality risk.

The process of identifying and assessing quality risks is depicted below.

### Identifying and Assessing Quality Risks



### c. Design and implement quality responses

.21 The firm must design and implement *quality responses* that (1) are based on the *quality risks* and the reasons for the assessments given to the *quality risks*, and (2) reduce to an appropriately low level the risk that the *quality objective* will not be achieved.

Note: Certain components include requirements for specified *quality responses*. These specified *quality responses* are to be included in the *quality responses* designed and implemented by the firm. Specified *quality responses* may address multiple *quality risks* within multiple components but are not intended to be comprehensive and alone will not be sufficient to enable the firm to achieve all established *quality objectives* of the firm's QC system. Depending on the *quality risk* being addressed, specified *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

The proposed standard would require the firm to design and implement quality responses that address quality risks in order to achieve the quality objectives. Quality responses are defined as policies and procedures designed and implemented by the firm to address quality risks. Under the proposed definition, policies are statements of what should, or should not, be done to address assessed quality risks. Such statements may be documented or explicitly stated in communications. Procedures are actions to implement and comply with policies.

Under the principles-based approach of the proposed standard, the nature, timing, and extent of quality responses would depend on the underlying quality risks and the reasons why these risks were assessed as quality risks. For example, a quality risk that was assessed to occur multiple times per year, or that could have a very significant impact, would require a more extensive response than a quality risk tied to a specific event that is expected to occur only once and have a less significant impact.

The firm may decide to implement quality responses at the firm level or the engagement level, or through a combination of responses at the firm and engagement levels, depending on the nature of the quality risk. Quality responses may address multiple quality risks related to one or more QC components.

Information obtained from the identification and assessment of quality risks would enable the firm to develop quality responses that appropriately and adequately respond to the quality risks. In assessing risks, the firm would consider how often the quality risks may occur and the magnitude of the impact of the quality risks on the related quality objectives. The firm

would then take this information into account in determining the nature, timing, and extent of the quality response(s) needed to address the quality risk.

In addition to the quality responses designed and implemented by the firm, the proposed standard would require certain specified quality responses for all firms. In general, the proposed specified quality responses are drawn from existing PCAOB requirements<sup>148</sup> or from the specified responses in ISQM 1,<sup>149</sup> and have been included either to carry existing requirements into the new standard or to create other obligations that would have to be met in designing, implementing, and operating the QC system. The specified quality responses are not intended to be comprehensive; on the contrary, for most of the components of the firm's QC system, the proposed standard includes only a few specified quality responses, and for the engagement performance component there are none. As a result, the specified quality responses alone would not be sufficient to enable the firm to achieve all established quality objectives, and firms would be required to design and implement their own quality responses in addition to the specified quality responses. The specified quality responses and the quality responses the firm designs and implements on its own would be critical in addressing quality risks.

For example, the specified quality response requiring mandatory training<sup>150</sup> may address some of the quality risks related to certain quality objectives in the resources component (e.g., hiring, developing, and retaining firm personnel).<sup>151</sup> However, mandatory training alone will not be sufficient to address all the quality risks that may be identified for that quality objective and would have to be combined with additional firm-developed quality responses.

**d. Modifications to the quality objectives, quality risks, or quality responses**

.22 In addition to identifying and assessing *quality risks* annually, the firm should establish policies and procedures to monitor, identify, and assess changes to conditions, events, and activities that indicate modifications to the firm's *quality objectives, quality risks, or quality responses* may be needed. Such policies and procedures should specify that the firm take into account, among other sources, information from the firm's monitoring and remediation process.

.23 If the firm identifies changes to conditions, events, or activities indicating that modifications to the *quality objectives, quality risks, or quality responses* may be needed, the

<sup>148</sup> See, e.g., QC 20.10, .13a, .13b, and .15a.

<sup>149</sup> See paragraph .34 of the ISQM 1.

<sup>150</sup> See QC 1000.48.

<sup>151</sup> See QC 1000.44a.

firm should determine what, if any, modifications are needed and make them on a timely basis.

The proposed standard would require firms to take proactive measures to address new quality risks that may come up between the firm's periodic risk assessments. To the extent practical, these policies and procedures would be not just retrospective, but also forward-looking, so the firm could anticipate and plan for significant changes. For example, a new accounting standard may result in a firm identifying a new quality risk that firm personnel may misinterpret the new standard. Identifying this risk prior to the next annual risk assessment may prompt the firm to revisit its quality objectives and quality responses that are affected by this event, and thus avoid potential problems in future engagements.

Policies and procedures in this area may vary, depending on the size and complexity of the firm and the types and variety of engagements it performs. For a larger firm operating in a complex environment and auditing a wide range of different types of companies, such policies and procedures would be extensive. For example, they could involve periodic meetings with teams across the firm to gather and analyze the necessary information to enable the firm to identify changes to conditions, events, and activities that may require modification of the firm's quality objectives, quality risks, or quality responses. Smaller and less complex firms, operating in a less varied and more stable environment, may have a less extensive set of policies and procedures.

If the firm identifies changes to conditions, events, or activities indicating modifications to the quality objectives, quality risks, or quality responses may be needed, the proposed standard would require the firm to determine what, if any, modifications are needed, and to make them on a timely basis. The timing would depend on the nature and extent of the modification needed. In some circumstances, immediate action may be required, whereas in other cases, if the impact on risk is less urgent, immediate action is not necessary. Modifications not implemented in a timely manner may fail to prevent quality risks from occurring and adversely affecting the quality objective. For example, in the case of a new accounting standard, the firm would need to implement any necessary modifications to its quality responses in time to provide assurance that, once the standard became effective, firm personnel would be able to apply it properly.

## **2. Current PCAOB standards**

Under current PCAOB QC standards, firms have a responsibility to establish and maintain a QC system to provide the firm with reasonable assurance that its personnel comply

with applicable professional standards and the firm's standards of quality. The current QC standards make few explicit statements about risk assessment.<sup>152</sup>

### 3. Key differences from other QC standards

The key differences between our proposed requirements for the firm's risk assessment process and the provisions of other QC standards are:

- Proposed QC 1000 would require the firm to identify and assess quality risks annually. The explicit reference to "annually" is not included in other QC standards' provisions regarding the identification and assessment of quality risks.
- Proposed QC 1000's definition of quality risks treats risks of intentional acts by firm personnel and other participants to deceive or to violate applicable professional and legal requirements differently than other risks. Other QC standards' definitions of quality risks do not separately address risks of intentional misconduct.
- Proposed QC 1000 refers to "other relevant information" in the context of obtaining an understanding of the conditions, events, and activities that may adversely affect the achievement of its quality objectives. A similar reference is not included in other QC standards.

### Questions

14. Are the proposed definitions of "quality risks," "quality objectives," and "quality responses" sufficiently clear and comprehensive? If not, why not?
15. Is the threshold of "adversely affecting" set out in the proposed definition of quality risk clear, or would more guidance and examples be helpful?
16. Should the proposed definition of "quality risks" explicitly address risks of intentional misconduct by firm personnel and other participants? If not, please explain why. Should the definition explicitly address other risks? If so, what are the other risks?

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<sup>152</sup> See, e.g., QC 20.16 (explaining that a firm's policies and procedures should provide for obtaining an understanding with the client about the services to be performed, to minimize the risk of misunderstandings); QC 30.05 (identifying risks associated with the firm's practice as a consideration in determining the need for and extent of internal inspection procedures in monitoring the firm's QC system).

17. In the proposed definition of “quality risks” should the threshold of “reasonable possibility of occurring” also apply to all risks, including risks of intentional misconduct by firm personnel and other participants? If so, why?
18. Are the proposed requirements for the firm’s risk assessment process appropriate? Are changes to the requirements necessary for this process? If so, what changes?
19. Are the proposed requirements sufficient to prompt firms to appropriately identify, assess, and respond to quality risks, or is supplemental direction needed? If supplemental direction is needed, what would assist firms in identifying, assessing, and responding to quality risks?
20. Are the specific examples included in Appendix B helpful in assisting the firm in identifying and assessing quality risks? Should additional examples or guidance be provided? If so, what additional examples or guidance would be helpful?

## E. Governance and Leadership

The governance and leadership component of the firm’s QC system addresses the environment that enables the effective operation of the QC system and directs the firm’s culture, decision-making processes, organizational structure, and leadership. A firm’s culture and tone, as set by leadership, can and should promote the importance of quality.

The PCAOB has long considered firm governance and leadership to be an important aspect of firms’ QC systems. For example, PCAOB inspections have historically covered the firm’s tone at the top, a foundational aspect of governance and leadership, during the process for reviewing firms’ QC systems.<sup>153</sup> PCAOB inspection procedures focus on how firm management is structured and whether actions and communications by the firm’s leadership—the tone at the top—demonstrates a commitment to audit quality.<sup>154</sup>

### 1. Proposed QC 1000

.24 The governance and leadership component addresses the environment that enables the effective oversight and operation of the QC system and directs the firm’s culture, decision-making processes, organizational structure, and leadership.

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<sup>153</sup> See, e.g., [Report on the PCAOB’s 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms](#), PCAOB Release No. 2008-008 (Dec. 5, 2008) at 6 and [Staff Inspection Brief, Vol. 2017/3: Information about 2017 Inspections \(Aug. 2017\)](#) at 8.

<sup>154</sup> See <https://pcaobus.org/oversight/inspections/inspection-procedures> for information related to the PCAOB’s inspection procedures.

### a. Governance and leadership quality objectives

Under proposed QC 1000, a firm would be required to establish quality objectives for the governance and leadership component in several different areas:

- The firm's commitment to quality;
- Organization and governance structure; and
- Resources.

#### i. The firm's commitment to quality

.25 The *quality objectives* established by the firm with respect to its governance and leadership should include the following:

- a. The firm's commitment to quality is communicated and promoted by leadership to recognize and reinforce:
  - (1) The firm's role in protecting the interests of investors and the public interest by consistently fulfilling its responsibilities under *applicable professional and legal requirements*;
  - (2) The importance of adherence to appropriate standards of conduct by *firm personnel*;
  - (3) The importance of professional ethics, values, and attitudes; and
  - (4) The expected behavior and responsibility of *firm personnel* for quality relating to activities that are subject to *applicable professional and legal requirements*, including activities within the firm's QC system and the firm's performance on *engagements*.
- b. The firm clearly defines leadership's responsibility for quality and holds leadership accountable.
- c. Leadership demonstrates a commitment to quality through its actions and behaviors.
- d. The firm's strategic decisions and actions, including financial and operational priorities, are consistent with and support the firm's commitment to quality.

The firm's commitment to quality is an important factor in influencing the behavior of firm personnel. We believe that the firm's commitment to quality is most effectively demonstrated through the communications, actions, behaviors, and directives of leadership at all levels of the firm, including firm-wide leadership, the executive team, and regional, office, and industry segment leadership. Accordingly, the quality objectives related to commitment to quality are directed at the communications, actions, and accountability of firm leadership.

Frequent and consistent communication from leadership to firm personnel regarding the commitment to quality is important in order to create an appropriate tone at the top. Proposed paragraph .25a. focuses on communicating and promoting key professional attributes by recognizing and reinforcing the firm's role in protecting the interests of investors and the public interest by meeting the firm's responsibilities, the importance of adhering to appropriate standards of conduct; the importance of professional ethics, values, and attitudes; and expected behavior and responsibility of firm personnel for quality both in QC-related activities and the performance of engagements. Collectively, these attributes and expected behaviors are the foundation of an effective QC system.

To achieve an appropriate tone at the top, however, it is not enough for firm leadership to "talk the talk." They also have to "walk the walk." Accordingly, proposed paragraphs .25b. and .25c. establish objectives with regard to leadership's responsibility for and commitment to quality, including through leadership's own behavior. For example, leadership would demonstrate a commitment to quality by acting in a manner consistent with the firm's communications described in paragraph .25a. regarding expectations of firm personnel. Conversely, repeated failure to take steps to address known quality concerns would demonstrate a lack of commitment to quality.

Proposed paragraph .25d. focuses on the firm's commitment to quality in relation to its strategic decisions and actions, which include matters such as the firm's financial goals, growth of the firm's market share, industry specialization, business combinations, new geographic markets, and new service offerings. The proposed quality objective would emphasize that a firm's strategic decisions and actions should be consistent with and support the firm's commitment to quality.

The concept release asked whether a proposed QC standard should expressly address quality considerations in the appointment of a firm's senior leadership. Many commenters, including firms and related groups, asserted that an incremental provision would not be necessary and that the requirements in ISQM 1 would be sufficient. We believe that the proposed quality objectives relating to the accountability and responsibility of leadership for quality, and the firm holding leadership accountable, are considerations the firm may take into account in the appointment of senior leadership as well as in the ongoing performance of leaders' roles. Proposed QC 1000 therefore does not add incremental provisions focused exclusively on the appointment of senior leadership.

## ii. Organizational and governance structure

- e. The firm's organizational and governance structure and the assignment of roles, responsibilities, and authority enable the design, implementation, and operation of the firm's QC system and support performance of the firm's *engagements* in accordance with *applicable professional and legal requirements*.

Establishing and maintaining appropriate firm organizational structures provides an institutional framework supporting the firm's QC system and the performance of the firm's engagements. Organizational structures may include operating units, operational processes, divisions, and geographical locations.

Firm organizational structures may differ based on the size and complexity of the firm in order to be flexible, scalable, and proportionate to the circumstances of the firm. Some firms may concentrate or centralize processes or activities and other firms may have a decentralized approach. Some firms may use internal shared service centers in the operation of the firm's QC system or to enable the performance of its engagements.

A firm's governance structure may include a governing board or committee with representation from various service lines, or with members who are independent of the firm.<sup>155</sup> Such a governing board may have subcommittees to assist it with managing specific areas, such as strategic planning, resource planning, the firm's risk assessment process, and the monitoring and remediation process.

Paragraph .25e. would drive a firm's organizational and governance structure to enable the design, implementation, and operation of the QC system and support performance of the firm's engagements in accordance with applicable professional and legal requirements. This results-oriented approach focuses on whether the QC system actually works as intended and would allow firms to tailor the establishment of their governance structure. Additionally, the firm would consider the complexity and operating characteristics of the firm as part of performing its risk assessment process and identifying quality risks.<sup>156</sup>

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<sup>155</sup> When we refer to independence in the context of firm governance, we mean the criteria typically applied to independent directors of issuers. *See, e.g., New York Stock Exchange ("NYSE") Listed Company Manual*, Section 303A.01-.02; Nasdaq Rule 5605(a)(2). This is distinct from the requirements for auditor independence from the audit client, discussed in Section IV.F.

<sup>156</sup> Appendix B includes an example regarding the existence and extent of governance structures providing oversight of leadership. *See proposed QC 1000.B2.g.*

The assignment of roles, responsibilities, and authority within the firm's organizational structure is a key aspect of the design, implementation, and operation of the QC system. Establishing clear roles and responsibilities and clear lines of authority helps to translate the broad institutional objectives of the QC system into individual actions to be performed and monitored, and for which individuals can be held accountable. The assignment of roles and responsibilities may vary across firms depending on the nature and circumstances of the firm and its engagements.<sup>157</sup> For example, in a smaller firm with a limited number of individuals in leadership roles, the individual with oversight of the firm may assume all of the roles and responsibilities related to the QC system. A larger firm may have multiple levels of leadership that align to the firm's organizational structure.

### iii. Resources

- f. Resource needs are planned for, and resources are obtained or developed and allocated or assigned, in a manner that enables the effective design, implementation, and operation of the firm's QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements*.

Note: Resources include people, financial, technological, and intellectual resources, and resources from a network or *third-party provider*.

The firm's resources<sup>158</sup> enable the operation of the firm's QC system and the performance of the firm's engagements. Firm leadership influences the nature and extent of the resources that the firm obtains, develops, uses, and maintains, and how those resources are allocated or assigned, including the timing of when they are used. This quality objective emphasizes the importance of the firm having the necessary resources, and allocating them appropriately, such that the firm's QC system is designed, implemented, and operated effectively and the firm's engagements are performed in accordance with applicable professional and legal requirements.

In the concept release, we asked whether a new PCAOB standard should provide greater emphasis on financial resources than ISQM 1, with an incremental, more specific requirement to direct firms to allocate sufficient financial resources to the audit and assurance practice. Many commenters indicated that ISQM 1 sufficiently addresses financial resources and an incremental requirement would be unnecessary. A few commenters suggested that there are

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<sup>157</sup> See IV.C Roles and Responsibilities component for a discussion of specific roles and responsibilities that are required to be assigned.

<sup>158</sup> See IV.I Resources component for a discussion of the different types of resources.

synergies across lines of business that benefit the audit practice, even if the financial resources are not allocated directly to audit.

We are not proposing to add incremental requirements related to allocating financial resources. The proposed quality objective focuses on the need to allocate resources in a way that enables an effective QC system and the performance of compliant engagements but leaves it up to the firm to determine an allocation of financial resources that would accomplish that.

#### **b. Governance and leadership specified quality responses**

.26 In designing and implementing *quality responses* to address the *quality risks* in the governance and leadership component, the firm should include the specified *quality responses* in paragraphs .27-.29. These specified *quality responses* alone will not be sufficient to enable the firm to achieve all established *quality objectives* for this component. Depending on the *quality risk* being addressed, specified *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

The proposed standard includes specified quality responses for the governance and leadership component of the firm's QC system. The firm would be required to include these specified quality responses when designing and implementing quality responses to address the quality risks in the governance and leadership component.

.27 The firm should establish and maintain clear lines of responsibility and supervision—including defining authorities, responsibilities, accountabilities, and supervisory and reporting lines for roles within the firm, up to and including the principal executive officer(s) or equivalent—within the QC system.

The concept release described a potential incremental provision that would require firms to make explicit assignments of supervisory responsibilities at successive levels within the firm up to the firm's chief executive officer or equivalent. Such a provision would be intended to promote clarity within a firm about where supervisory responsibility rests and avoid ambiguity that could lead to ineffective supervision and increased risk of violating applicable professional and legal requirements.

The firms and related groups that commented on this point all argued against an incremental requirement, saying that the requirements in proposed ISQM 1 would be sufficient. Some of these firms observed that many firms already have such structures in place and suggested that a requirement may impede scalability. Other commenters supported establishing such a requirement, on the basis that it would enhance accountability.

We are proposing to include in QC 1000 a requirement for the firm to establish and maintain clear lines of responsibility and supervision within its QC system. We believe that establishing and maintaining structures within the firm—including defining authorities, responsibilities, accountabilities, and supervisory and reporting lines for roles within the firm—could support the effective design and operation of the QC system and the performance of the firm’s engagements. The proposed requirement is intended to enhance supervision within the context of firms’ existing QC systems and supervisory structures, without requiring firms to develop or adopt any particular supervisory structure. The requirement would also complement Section 105(c)(6) of Sarbanes-Oxley<sup>159</sup> and, with respect to the QC system, the documentation requirements of proposed QC 1000.<sup>160</sup>

.28 If the firm issued audit reports with respect to more than 100 issuers during the prior calendar year, the firm’s governance structure should incorporate an oversight function for the audit practice that includes at least one person who is not a partner, shareholder, member, other principal, or employee of the firm and does not otherwise have a commercial, familial, or other relationship with the firm that would interfere with the exercise of independent judgment with regard to matters related to the QC system.

The concept release acknowledged that some of the largest firms have independent directors or have established alternative means of external oversight, such as advisory committees, and asked whether a future QC standard should incorporate mechanisms for independent oversight of a firm’s QC system. Independent governance of registered firms has long been suggested as a means of improving audit quality.<sup>161</sup> Some commenters, including investors and investor advocates, expressed support for requiring independent oversight, at least for the largest firms. Several other commenters, including firms and related groups, were

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<sup>159</sup> Under Section 105(c)(6) of Sarbanes-Oxley, if an associated person of a registered public accounting firm violates any provision of law, rules, or standards referenced in Section 105(c)(6), the Board may impose sanctions on the firm or its supervisory persons if the Board finds that there was a failure reasonably to supervise that associated person with a view to preventing such a violation. The Board has adopted a rule related to Section 105(c)(6) that provides for commencing a disciplinary proceeding if it appears that a firm or its supervisory personnel have failed reasonably to supervise an associated person who has committed a violation. See PCAOB Rule 5200(a)(2); see also, e.g., *In the Matter of Scott Marcello, CPA*, PCAOB Release No. 105-2022-004 (Apr. 5, 2022) (imposing sanctions under Section 105(c)(6)); *In the Matter of WWC, P.C.*, PCAOB Release No. 105-2022-006 (Apr. 19, 2022) (same); *In the Matter of KPMG Inc., Cornelis Van Niekerk, and Coenraad Basson*, PCAOB Release No. 105-2022-015 (August 29, 2022) (same).

<sup>160</sup> See paragraph .82a. of the proposed standard for a description of the documentation requirements related to lines of responsibility and supervision.

<sup>161</sup> See, e.g., Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury (Oct. 6, 2008), at VII: 8-11.

opposed, suggesting that independent oversight may be a challenge for smaller firms to implement, may not be effective for some or all firms, and may create liability concerns or difficulties in complying with auditor independence requirements. Some firms indicated that independent oversight could take a variety of forms and argued that firms should have flexibility in selecting an approach that would work in their particular circumstances.

We are proposing to require firms that issued more than 100 audit reports for issuers in the prior calendar year to establish a governance structure that incorporates an oversight function for the audit practice including at least one person who is not a partner, shareholder, member, other principal, or employee or has a commercial, familial, or other relationship with the firm that would interfere with the exercise of independent judgment with regard to matters related to the QC system. We understand such governance structures may be challenging for some firms to implement based on their size and circumstances. Proposing a threshold for a firm's obligation based on the number of issuer clients may be appropriate because we believe firms with larger audit practices are generally subject to quality risks for which independent governance structures would be an appropriate quality response, and that the public interest in such firms is greater because of the large percentage of issuer audits that they perform.<sup>162</sup> We propose to base the requirement on the size of a firm's issuer audit practice rather than its broker-dealer audit practice, as we believe the number of a firm's issuer clients is more indicative of the firm's size and the complexity of its practice. In addition, we believe firms with over 100 issuer clients typically have the resources to implement such structures, and based on our oversight activities, some firms already have non-employee governance structures.<sup>163</sup> We believe firms are familiar with the proposed threshold of audit reports for more than 100 issuers, because it is used to determine which firms are subject to annual PCAOB inspection.<sup>164</sup>

The requirements we are proposing would not specify how the firm would establish its governance structure or assign authority, other than having at least one person in an oversight role who would be in a position to exercise independent judgment with regard to QC matters. As proposed, the person in the oversight role could be, but would not be required to be, in the "chain of command" under the SEC independence rule.<sup>165</sup> This would enable the firm, in the context of its own organizational structure, to address concerns such as the liability and

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<sup>162</sup> The 10 largest firms together audit the financial statements of approximately two-thirds of all U.S. reporting companies, and the four largest firms together audit the financial statements of over 85% of all large accelerated filers. Audit Analytics, *Who Audits Public Companies—2022 Edition* (June 28, 2022), available at <https://blog.auditanalytics.com/who-audits-public-companies-2022-edition/>.

<sup>163</sup> In 2021, we observed the largest six firms had some form of governance structure that included a non-employee.

<sup>164</sup> See Section 104(b)(1)(A) of Sarbanes-Oxley, 15 U.S.C. § 7214(b)(1)(A); PCAOB Rule 4003, *Frequency of Inspections*.

<sup>165</sup> See Regulation S-X Rule 2-01(f)(8), 17 C.F.R. § 210.2-01(f)(8).

independence challenges identified by commenters. While the proposed requirement specifies that such oversight be over the audit practice, the firm may choose to extend it more broadly.

.29 The firm should design, implement, and maintain policies and procedures for addressing and resolving potential noncompliance with *applicable professional and legal requirements* and with the firm's policies and procedures with respect to the QC system, the firm's *engagements, firm personnel, or other participants*, including for:

- a. Receiving complaints and allegations from internal and external parties (for example, policies and procedures regarding a complaints mailbox or hotline or a whistleblower program); and
- b. Investigating and addressing complaints and allegations.

Note: The nature, timing, and extent of the process to investigate and resolve complaints and allegations should be commensurate with and responsive to the significance of the related complaint or allegation.

Under this requirement, the firm would establish policies and procedures for dealing with complaints and allegations about noncompliance with applicable professional and legal requirements and the firm's policies and procedures. This includes clearly defining channels within the firm that enable reporting of complaints and allegations by firm personnel and external parties (e.g., employees of clients or other participants) and establishing procedures for appropriately investigating and addressing such complaints and allegations, including complying with any applicable reporting or other requirements.<sup>166</sup>

Through their knowledge of the circumstances and individuals involved, people internal and external to the firm can help a firm identify instances of noncompliance earlier than might be possible through the firm's own monitoring. Establishing policies and procedures that support the reporting and investigation of potential noncompliance may assist the firm in preventing engagement reports from being issued that are inappropriate. It may also assist the firm in identifying and dealing with individuals, including those in leadership, who fail to comply with applicable professional and legal requirements or the firm's policies and procedures.

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<sup>166</sup> A firm's whistleblower program may be subject to requirements under applicable law (such as, for example, N.Y. Labor Law Section 740). In addition, through this process information may be received regarding a client's noncompliance with laws and regulations. A firm's whistleblower program should not be confused with a whistleblower program established and administered by the federal government, including the program administered by the SEC, which has its own requirements and protections. See, e.g., Section 21F of the Exchange Act, 15 U.S.C. § 78u-6; 17 C.F.R. §§ 240.21F-1 through .21F-18.

Finally, it may result in firm personnel or external parties identifying and communicating deficiencies in the QC system.

The required policies and procedures regarding investigation and resolution of complaints and allegations are intended to allow scalability. The process for investigating and addressing a complaint or allegation would vary, commensurate with and responsive to the significance of the complaint or allegation.

## **2. Current PCAOB standards**

Existing PCAOB QC standards contain limited references to firm governance and leadership. For example:

- QC 20 acknowledges that the QC system includes the firm's organizational structure;<sup>167</sup>
- The SECPS member requirements on independence quality controls provide that the importance of compliance with such independence standards, and the QC standards, should be reinforced by management of the member firm, thereby setting the appropriate tone at the top and instilling its importance into the professional values and culture of the member firm;<sup>168</sup> and
- The SECPS member requirements provide that member firms should communicate to all professional firm personnel the broad principles that influence the firm's quality control and operating policies and procedures on, at a minimum, matters related to the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided, and inform professional firm personnel periodically that compliance with those principles is mandatory.<sup>169</sup>

## **3. Key differences from other QC standards**

Other QC standards do not contain provisions analogous to our proposed specified quality responses on the requirements to establish and maintain clear lines of responsibility and supervision or independent governance.

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<sup>167</sup> See QC 20.04.

<sup>168</sup> See SECPS § 1000.46.

<sup>169</sup> See SECPS § 1000.08(l).

## Questions

21. Are the proposed quality objectives for governance and leadership appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?
22. For the proposed specified quality response related to the firm's governance structure, is the threshold (firms that issued audit reports with respect to more than 100 issuers during the prior calendar year) appropriate? If not, what is an appropriate threshold?
23. Is the proposed specified quality response to incorporate an oversight function for the audit practice for firms that issue auditor reports with respect to more than 100 issuers appropriate? If not, why not?
24. Is the proposed specified quality response related to the firm's policies and procedures on receiving and investigating complaints and allegations appropriate? Are there any other specified quality responses in this area that we should consider, and if so, what are they?
25. Are there any other specified quality responses for the governance and leadership component that we should consider? If so, what are they?

## F. Ethics and Independence

This component addresses the fulfillment of firm and individual responsibilities under relevant ethics and independence requirements. As one commenter on the concept release noted, adhering to such requirements is a foundational concept that not only promotes audit quality but also safeguards the vital role that auditors play within the capital markets.

In the concept release, we noted that the "relevant ethical requirements" component of ISQM 1 was particularly focused on the *International Code of Ethics for Professional Accountants (including International Independence Standards)* of the International Ethics Standards Board for Accountants ("IESBA"). By contrast, we anticipated that a PCAOB QC standard would be focused on the U.S. regulatory environment, incorporating terminology, key concepts, and requirements under existing PCAOB ethics and independence standards and PCAOB and SEC independence rules. Several commenters, including firms, supported the potential differences from ISQM 1 described in the concept release, while other firms thought that incremental requirements were not necessary.

The ethics and independence component of the proposed standard has been tailored to the ethics and independence requirements that apply to engagements performed under PCAOB standards. Under the proposed standard, ethics and independence requirements would include the PCAOB's ethics and independence standards and rules, the SEC's rule on auditor independence, and other applicable requirements regarding accountant ethics and independence, such as those arising under state law or the law of other jurisdictions (e.g.,

obligations regarding client confidentiality).<sup>170</sup> The proposed standard would require firms to establish quality objectives related to ethics and independence requirements and design and implement specified quality responses.

### 1. Proposed QC 1000

.30 The ethics and independence component addresses the fulfillment of firm and individual responsibilities under ethics and independence requirements.

#### a. Ethics and independence quality objectives

The proposed standard would require the firm to establish the following quality objectives:

.31 The *quality objectives* established by the firm with respect to ethics and independence requirements should include the following:

- a. Ethics and independence requirements are understood and complied with by the firm and *firm personnel* and, with respect to work performed on behalf of the firm, by others subject to such requirements.
- b. Conditions, events, relationships, or activities that could constitute violations of ethics and independence requirements are properly identified, evaluated, and responded to by the firm and *firm personnel* on a timely basis.
- c. Violations are communicated on a timely basis to the individual assigned operational responsibility for the firm's compliance with ethics and independence requirements.

Understanding of and compliance with ethics and independence requirements are fundamental to the auditor's role. We believe that adherence to standards of professional

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<sup>170</sup> Footnote 11 to proposed QC 1000 provides:

Ethics and independence requirements include PCAOB independence and ethics standards and rules, the SEC rule on auditor independence, and other applicable requirements regarding accountant ethics and independence, such as those arising under state law or the law of other jurisdictions. *See, e.g.*, Regulation S-X Rule 2-01, 17 C.F.R. § 210.2-01, and PCAOB rules under Section 3. Auditing and Related Professional Practice Standards, Part 5 – Ethics and Independence.

ethics is as important as adherence to requirements regarding auditor independence, and that firms' QC systems should address both. Under the proposed standard, firms would be required to establish quality objectives that would address understanding of and compliance with ethics and independence requirements. While maintaining independence and adhering to ethical requirements is each individual's responsibility, the firm has a critical role to play in ensuring that individuals understand those requirements and have the tools and resources they need to comply.

Under the proposed standard, the firm would be required to establish a quality objective to identify conditions, relationships, events, or activities that could result in violations of ethics and independence requirements and evaluate and respond to them on a timely basis. This could help the firm reduce the risk of noncompliance by identifying potential violations of ethics and independence requirements in time to prevent many violations and to quickly remediate violations that do occur. For example, a firm that plans to acquire another firm could identify the acquisition as an event that could result in independence violations by the personnel of the acquired entity. This could prompt the firm to develop policies and procedures that address onboarding processes for firm personnel of acquired entities around independence. These policies and procedures would assist in identifying and resolving potential independence violations before the acquisition is completed.

Firms would be required to establish quality objectives that address both personal and firm-level compliance. Personal violations could include such matters as owning stock in companies that are audit clients of the firm or its affiliated entities while a "covered person in the firm."<sup>171</sup> Firm-level violations could include such matters as providing prohibited services or failing to obtain required audit committee pre-approval.

The quality objectives would address compliance with ethics and independence requirements not just by firm personnel, but also by others who may be subject to ethics and independence requirements in relation to work they perform on behalf of the firm. These others may include, for example, "persons associated with a public accounting firm"<sup>172</sup> or "covered persons in the firm."<sup>173</sup> We note that these and other concepts used in the ethics and independence rules do not map directly to the terminology we generally use in proposed QC 1000. (For example, some "other participants," such as other accounting firms, are subject to independence requirements, while others, such as engaged specialists and the company's internal auditors, are not.) To ensure that the requirements for this component of the QC

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<sup>171</sup> See Regulation S-X Rule 2-01(f)(11), 17 C.F.R. § 210.2-01(f)(11).

<sup>172</sup> See PCAOB Rule 1001(p)(i).

<sup>173</sup> For example, because the definition of "accounting firm" under Regulation S-X Rule 2-01(f)(2) includes associated entities, "covered persons in the firm" may include personnel of network affiliates in addition to firm personnel.

system align with the ethics and independence requirements over which the QC system would operate, in this component we propose to use terminology that incorporates or refers back to the underlying ethics and independence requirements. For example, rather than having quality objectives address compliance by “other participants,” in this component the quality objective would address compliance by “others subject to [ethics and independence] requirements.”

With respect to the timing of communications of violations to the individual assigned operational responsibility for the firm’s compliance with applicable ethics and independence requirements, the proposed quality objective states that such actions should take place on a timely basis.

#### **b. Ethics and independence specified quality responses**

.32 In designing and implementing *quality responses* to address the *quality risks* in the ethics and independence component, the firm must include the specified *quality responses* in paragraphs .33 -.36. These specified *quality responses* alone will not be sufficient to enable the firm to achieve all established *quality objectives* for this component. Depending on the *quality risk* being addressed, specified *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

The proposed specified quality responses are based on existing PCAOB ethics and independence requirements and SEC independence requirements, including the provisions regarding independence quality controls that currently apply to SECPS member firms.<sup>174</sup> In the concept release, we stated that we were considering incorporating those requirements—with some updates and refinements—and extending them to all firms, because the requirements address independence matters generally relevant to all firms’ compliance with PCAOB and SEC independence rules.

Firms and related groups generally supported that approach. Some stated that any updates should be principles-based, use a risk-based approach, and generally be extended to all firms. One firm suggested that the SECPS member requirements were sufficiently reflected in provisions of ISQM 1 and it would not be necessary to include the detailed existing requirements in a future PCAOB QC standard. However, the firm supported application to all firms if the Board decided to retain these requirements in a new standard. Another firm opposed application of SECPS member requirements to all firms as too prescriptive.

We are proposing to incorporate SECPS member requirements into QC 1000, with some refinements, and to extend those requirements to all firms. Our preliminary view is that the

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<sup>174</sup> See SECPS § 1000.46.

SECPS requirements address matters that are generally relevant to a QC system operating over compliance with SEC and PCAOB independence rules. Since those rules apply to all firms that perform engagements for issuers and broker dealers, we believe it may be appropriate to extend the SECPS requirements to all firms.

Under the proposed standard, the firm would be required to design, implement, and maintain policies and procedures for the following:

- General ethics and independence matters;
- Certain specific matters that may reasonably be thought to bear on independence;
- Communication regarding ethics and independence policies and procedures; and
- Mandatory training on ethics and independence.

i. [QC policies and procedures about general ethics and independence matters](#)

The proposed standard would require the adoption of policies and procedures regarding general ethics and independence matters, carrying forward current PCAOB and SEC requirements.

.33 The firm must design, implement, and maintain policies and procedures that address ethics and independence requirements, including:

- a. Identifying and addressing matters that may reasonably be thought to bear on the independence of the firm, *firm personnel*, and affiliates of the firm;

The phrase “may reasonably be thought to bear on independence” is used in PCAOB Rule 3526<sup>175</sup> and should be familiar to all firms. It is taken from an independence standard that predates the existence of the PCAOB,<sup>176</sup> and, as we noted in connection with the adoption of Rule 3526, it focuses auditors on the perceptions of reasonable third parties when making independence determinations. It is consistent with the SEC’s general standard on

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<sup>175</sup> See PCAOB Rule 3526 (requiring auditors to describe to the audit committee relationships that may reasonably be thought to bear on independence).

<sup>176</sup> See *Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees*. ISB No. 1 was included in the Board’s interim standards until it was superseded by the adoption of Rule 3526.

independence<sup>177</sup> and AS 1005, *Independence*. The firm's policies and procedures would be required to address all matters that may reasonably be thought to bear on the independence of the firm, firm personnel, and affiliates of the firm under SEC and PCAOB rules.

In addition to the broad concept of matters that "may reasonably be thought to bear on independence," SEC and PCAOB rules address certain specific matters that bear on independence. For example, Rule 2-01(c) of Regulation S-X sets forth a nonexclusive list of circumstances that the SEC considers to be inconsistent with firm independence.<sup>178</sup> Such circumstances include, among others, certain financial relationships, employment relationships, business relationships, non-audit services, contingent fees, and circumstances related to partner rotation. PCAOB rules also list certain prohibited tax transactions and tax services that would make the firm not independent of its client.<sup>179</sup>

The underlying facts and circumstances and relevant requirements will determine what actions need to be taken by the firm to address a matter that may reasonably be thought to bear on independence. For example, in some situations, it will be sufficient to communicate the matter to the audit committee. In other situations, further action may be required.

- b. Obligations of *firm personnel* to perform with integrity and objectivity all activities associated with the operation of the QC system and the performance of *engagements* (such as training and other professional development activities; *engagement* planning, performance, and supervision; and communication with clients, other *firm personnel*, and regulators);
- c. Obligations of associated persons of the firm, other than *firm personnel*, to perform work on behalf of the firm with integrity and objectivity;

Integrity and objectivity are important ethical concepts currently addressed in QC 20.<sup>180</sup> Under the existing standard, integrity requires personnel to be honest and candid within the constraints of client confidentiality, whereas objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Commenters generally supported retaining these existing concepts in a future PCAOB QC standard. One commenter recommended that an annual written acknowledgment be obtained from relevant personnel regarding their compliance with certain fundamental ethics requirements, including, among

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<sup>177</sup> See Regulation S-X Rule 2-01(b), 17 C.F.R. § 210.2-01(b).

<sup>178</sup> See Regulation S-X Rule 2-01(c), 17 C.F.R. § 210.2-01(c).

<sup>179</sup> See PCAOB Rule 3522, *Tax Transactions*; PCAOB Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*.

<sup>180</sup> See QC 20.10.

other things, the integrity and objectivity concepts in QC 20 and client confidentiality. We preliminarily believe that the audit firm should have flexibility to determine whether and when to obtain any written certification or acknowledgement, whether to adopt a firm-wide code of ethics or similar protocol, or otherwise how to respond to the specific risks faced by the firm and firm personnel. We are seeking comment on whether proposed QC 1000 should have a separate requirement for an annual written acknowledgement of specified ethics requirements, as well as whether it should require or encourage firms to adopt a code of ethics or adopt any other specific policies to encourage ethical behavior.

We propose to rescind our interim ethics and independence standard, ET 102, *Integrity and Objectivity*, and replace it with a new standard, EI 1000, *Integrity and Objectivity*.<sup>181</sup> QC 1000 would include a reference to that new rule and to PCAOB Rule 3500T, *Interim Ethics and Independence Standards*.

The proposed QC standard clarifies that firm personnel would be expected to demonstrate integrity and objectivity in carrying out all of their professional responsibilities associated with the QC system and the performance of engagements. This includes activities ranging from the design and implementation of the QC system, monitoring and remediation, and evaluation of the QC system, to training and professional development; planning, performing, and supervising engagements; and internal and external communications. We also believe that it is important for the firm's policies and procedures to address obligations related to integrity and objectivity for associated persons of the firm, other than firm personnel, who perform work on behalf of the firm.

d. Consultations on ethics and independence matters, including identifying ethics and independence matters requiring consultation;

Establishing a consultation process on independence matters is an existing concept under SECPS independence requirements. Currently, SECPS member firms are required to designate a senior-level partner responsible for overseeing the adequate functioning of the firm's independence policies and consultation process.<sup>182</sup>

We propose to expand this concept in QC 1000 by covering not only independence matters, but also ethics matters, and by expressly requiring the firm's policies and procedures to address the identification of ethics and independence matters that require consultation. The specific focus on identifying matters requiring consultation could prompt firm personnel and

<sup>181</sup> See Section V.B, Proposed Rescission of ET Section 102; Proposed new standard EI 1000; proposed amendments to ET Section 191.

<sup>182</sup> See SECPS § 1000.46 (requirement 5).

other participants to more effectively identify ethics and independence issues that are new, challenging, or complex and that would benefit from evaluation by subject matter experts. We also propose to apply the requirement to all firms, not just SECPS member firms.

- e. Monitoring compliance (e.g., internal inspection of independence compliance at least annually) with applicable ethics and independence requirements and related firm policies and procedures by the firm, affiliates of the firm, *firm personnel*, and, with respect to work performed on behalf of the firm, others subject to such requirements; and

Under existing SECPS requirements, member firms are required to establish a monitoring system to determine that corrective actions are taken on all apparent independence violations reported by firm personnel.<sup>183</sup> Under those requirements, the monitoring system should include procedures to provide reasonable assurance that (i) investments of the firm and its benefit plans are in compliance with the firm's policies and (ii) information received from its partners and managers is complete and accurate. The SECPS requirements do not prescribe specific activities for the monitoring system, other than stating that generally it includes auditing, on a sample basis, selected information such as brokerage statements, or alternative procedures that accomplish the same objective. Similarly, the proposed standard does not prescribe specific activities to monitor compliance with ethics and independence requirements and the firm's ethics and independence policies. This would allow scalability based on the firm's size and specific circumstances. We expect that firms that have developed monitoring systems to comply with SECPS requirements would continue to use these systems as one aspect of monitoring compliance under the proposed standard.

With respect to compliance with applicable ethics and independence requirements by the firm and its affiliates, we understand that firms employ various manual and automated tools for evaluating whether the firm and its affiliates comply with SEC and PCAOB independence requirements and the firm's independence policies and procedures. Some examples of such tools include having a centralized process to monitor business relationships, establishing an independence confirmation process that includes detailed guidance and questions related to independence and prohibited non-audit services, and periodic review of the completeness and accuracy of information reported on independence confirmations.

A firm may establish ethics and independence policies and procedures that are more restrictive than the rules of the SEC and PCAOB—for example, to comply with requirements of other jurisdictions or to simplify compliance with SEC and PCAOB requirements by setting

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<sup>183</sup> See SECPS § 1000.46 (requirement 7.d).

bright-line policies and reducing the range for individual judgment. Under the proposed approach, the firm's evaluation of compliance would cover applicable ethics and independence requirements as well as the firm's policies and procedures.

f. With respect to violations and potential violations of ethics and independence requirements:

- (1) Identifying conditions, events, relationships, or activities that could constitute ethics or independence violations involving the firm, *firm personnel*, and, with respect to work performed on behalf of the firm, others subject to such requirements;
- (2) Taking preventive and corrective actions to address ethics or independence violations, as appropriate, on a timely basis;
- (3) Reporting requirements for *firm personnel* and, with respect to work performed on behalf of the firm, *other participants* regarding ethics or independence violations of which they become aware that may affect the firm, including requirements for escalating reporting of such violations; and
- (4) Communicating, as appropriate, to external parties (for example, to audit committees).

As previously discussed, we are building into proposed QC 1000 the existing SECPS requirement for firms to have policies and procedures that address independence violations and expanding the requirement to cover all firms and to include ethics violations.

Under the proposed standard, the firm would be required to establish policies and procedures addressing violations and potential violations of ethics and independence requirements. These types of policies and procedures are intended to be preventive, detective, and corrective by nature.

The firm's policies and procedures would be required to address identifying conditions, events, relationships, or activities that could constitute ethics or independence violations involving the firm, firm personnel, and, with respect to work performed on behalf of the firm, others subject to such requirements. For example, if a firm or its network is contemplating a reorganization or restructuring that would affect the relationships among affiliated firms or other entities, identifying post-reorganization investment activities as such an activity could assist the firm in designing and implementing appropriate policies to prevent independence violations. With respect to ethics and independence violations that do or could occur, the firm's policies and procedures would also be required to address the taking of preventive and

corrective actions to address violations on a timely basis. Such policies and procedures could specify the individuals responsible for taking preventive and corrective actions (at the engagement or firm level), the timing of preventive and corrective actions, and any potential sanctions against firm personnel or other individuals for violating ethics and independence requirements.

The firm's policies and procedures would also be required to address reporting of ethics and independence violations. The reporting obligation under proposed QC 1000 is not limited in the same way as under SECPS requirements. While SECPS requirements require personnel to report only their own personal independence violations, proposed QC 1000 is not similarly limited, and contemplates reporting with respect to all ethics and independence violations of which firm personnel and other participants become aware that may affect the firm. The commenters who addressed this potential requirement generally supported extending the reporting requirement beyond personal violations to cover all violations affecting the firm's independence.

The proposed standard takes a principles-based approach, which would allow each firm to determine which reporting mechanisms best fit its structure and address its quality risks. Through our oversight activities, we have observed that firms employ various mechanisms for firm personnel to report violations. Some examples include direct communication lines to an ethics and independence group, designated individuals within the human resources department, or the legal department, and whistleblower hotlines. Firms may assess each case individually and involve appropriate subject matter experts, depending on the nature of the violation. Some firms also establish escalation protocols for certain types of ethics and independence violations (e.g., violations involving a partner in the firm).

In addition, the firm's policies and procedures would be required to address any communications that need to take place as a result of a violation of ethics and independence requirements. For example, PCAOB Rule 3526 requires certain communications to the audit committee regarding matters that are thought to bear on the firm's independence, including violations of independence requirements.

ii. [QC policies and procedures about certain matters that may reasonably be thought to bear on independence: restricted entities, independence certifications, and matters requiring audit committee pre-approval](#)

Under the proposed standard, the firm's policies and procedures on matters that may reasonably be thought to bear on the independence of the firm would be required to address, among other things, (1) restricted entities, including the maintenance and dissemination of the list of restricted entities ("the Restricted List"); (2) independence certifications; and (3) matters requiring audit committee pre-approval.

## 1) Restricted entities

.34 The firm's policies and procedures for matters that may reasonably be thought to bear on the independence of the firm, *firm personnel*, and affiliates of the firm (see paragraph .33a.) must include:

- a. Identifying firm and personal relationships and arrangements with restricted entities, including a process for identifying direct or material indirect financial interests that might impair the firm's independence of *firm personnel* that are managerial employees or partners, shareholders, members, or other principals.

- (1) If the firm issued audit reports with respect to more than 100 issuers during the prior calendar year, such process should be automated.

- (2) If the firm issued audit reports with respect to 100 or fewer issuers during the prior calendar year, the firm should consider automating such process, taking into account the *quality risks* and the nature and circumstances of the firm.

Note: Firm and personal relationships and arrangements with restricted entities include financial relationships, employment relationships, business relationships, non-audit services, contingent fee arrangements, partner rotation, certain tax services, and arrangements requiring audit committee pre-approval. The term "restricted entities" includes all audit clients (including affiliates of the audit client) of the firm and affiliates of the firm.

- b. Maintaining and making available the list of restricted entities to *firm personnel* and others performing work on behalf of the firm who are subject to independence requirements;

Note: This includes updating and communicating changes to the list of restricted entities at least monthly (and more frequently, if appropriate) to *firm personnel* and others performing work on behalf of the firm who are subject to independence requirements.

- c. Requiring that the list of restricted entities be reviewed before the firm enters into any relationships, *engagements* to perform non-audit services, or fee arrangements that might affect compliance with independence requirements, and, if such review indicates that action is required under *applicable professional and legal requirements* or the firm's policies and procedures, taking required actions on a timely basis;

- d. Requiring *firm personnel* to review the list of restricted entities (1) upon employment or engagement, (2) after changes to the list of restricted entities are

communicated by the firm, (3) prior to themselves or a relevant family member obtaining any direct or material indirect financial interest in or entering into or modifying a direct or material indirect relationship with an entity, (4) prior to changes in position (e.g., going into a chain of command or other covered person role), and (5) prior to entering into any business or employment relationships, and, if such review indicates that action is required under *applicable professional and legal requirements* or the firm's policies and procedures, taking required actions on a timely basis;

Most of the proposed requirements related to restricted entities come from existing SECPS member requirements,<sup>184</sup> which would be applied to all firms. Under the proposed standard, as under current requirements, restricted entities would include all audit clients, including affiliates of the audit client, of the firm and affiliates of the firm. "Audit client," "affiliate of the audit client," and "affiliate of the accounting firm" are terms defined in existing PCAOB and SEC rules.<sup>185</sup>

Existing SECPS requirements require firms that audit more than 500 SEC registrants to have an automated system to identify investment holdings of partners and managers that might impair independence.<sup>186</sup> Some commenters, including a firm and related groups, expressed concern over the costs associated with requiring all firms to have an automated system.

Rather than requiring all firms to have an automated system, we are proposing to require an automated system for only those firms that issued audit reports with respect to more than 100 issuers during the prior calendar year. We understand that firms that audit more than 500 SEC registrants already have automated systems in place, based on the SECPS

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<sup>184</sup> The SECPS term "restricted entities" includes all audit clients of the firm (and, where applicable, its foreign-associated firms) that are SEC registrants, along with other entities that the firm is required to be independent of under the applicable SEC requirements.

<sup>185</sup> "Audit client" is defined for purposes of SEC rules in Regulation S-X Rule 2-01(f)(6), 17 C.F.R. § 210.2-01(f)(6) and for purposes of PCAOB rules in PCAOB Rule 3501(a)(iv). "Affiliate of the audit client" is defined in PCAOB Rule 3501(a)(ii) as having the same meaning as defined in Regulation S-X Rule 2-01(f)(4), 17 C.F.R. § 210.2-01(f)(4). "Affiliate of the accounting firm" is defined in PCAOB Rule 3501(a)(i) and, for purposes of this Note 1 to paragraph .33a. "accounting firm," which includes the firm's associated entities, is defined in Regulation S-X Rule 2-01(f)(2), 17 C.F.R. § 210.2-01(f)(2).

<sup>186</sup> See SECPS § 1000.46 (requirement 4).

requirements to have an automated system and Regulation S-X Rule 2-01(d).<sup>187</sup> Firms that issued audit reports for 100 or fewer issuers would be required to consider whether the system needs to be automated, taking into account the quality risks and the nature and circumstances of the firm. For example, a firm with close to 100 SEC-registered clients and a significant number of managers and partners may assess timely identification of personal investments that may impair independence as a quality risk, and a quality response to address that risk may include an automated system to help facilitate a more timely relationship-checking process.

The proposed standard does not prescribe a specific process for maintaining and making available the Restricted List to firm personnel and other individuals. Firms would be able to determine the specific methods and tools needed to keep the Restricted List up to date and to ensure that any changes are communicated on a timely basis to firm personnel and other individuals. This determination could be based on factors such as the size of the firm, the number of audit clients, and the complexity of those clients (e.g., the number of audit client affiliates). For example, a smaller firm with a small group of professionals, a stable portfolio of audit clients, and a manual process for maintaining the Restricted List may decide to communicate changes monthly. For a larger firm with many audit clients and firm affiliates, an automated tool could help facilitate more frequent updates to the Restricted List.

Current SECPS requirements require timely (generally monthly) communication of changes to the Restricted Entity List.<sup>188</sup> We propose to clarify that such communication is to be made to all firm personnel and others subject to independence requirements on at least a monthly basis. Some firms may decide to communicate updates to the Restricted List on a more frequent basis, as changes are being made, or in more targeted ways (such as to particular offices or engagement teams) in addition to more general communications to all firm personnel. The proposed standard does not prescribe the method of communication. Through our oversight activities, we have observed that some firms comply with existing SECPS requirements by communicating changes to the Restricted List to all firm personnel weekly via e-mail. These firms could continue that practice to comply with the proposed standard. However, other methods that result in an effective communication would also be acceptable.

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<sup>187</sup> Regulation S-X Rule 2-01(d) provides that a firm's independence is not impaired solely because a covered person in the firm is not independent of an audit client, provided the covered person did not know of the circumstances giving rise to the violation, the violation was corrected as promptly as possible, and the firm maintains a quality control system meeting specified standards. Regulation S-X Rule 2-01(d)(4), 17 C.F.R. § 210.2-01(d)(4), describes, for firms that provide audit, review, or attest services to more than 500 SEC registrants, features necessary for the firm's QC system to meet the specified standards, including an automated system to identify investment holdings of partners and managers that might impair independence.

<sup>188</sup> See SECPS § 1000.46 (requirement 5).

With respect to timing for updating and communicating changes to the Restricted List, the proposed standard includes a note to clarify that updating and communicating changes to the Restricted List would be done at least monthly and more frequently, if appropriate.<sup>189</sup>

One firm noted that a requirement to maintain a list of restricted entities would not need to be implemented by each member firm of a network, if the network maintains a database of restricted entities. We recognize that some firms are members of networks that may develop systems, processes, and controls to monitor network firms' compliance with independence requirements, including maintaining a database of restricted entities. As described above, the proposed standard does not prescribe a specific process for maintaining a database of restricted entities, so this process could potentially be performed by a network or outsourced to a third party. At the same time, the proposed standard would require each firm to establish its own quality objective, which would place responsibility on the firm with respect to resources or services provided by the network or a third-party provider.<sup>190</sup>

We are incorporating into proposed QC 1000 the existing SECPS requirements for firm personnel<sup>191</sup> to review the Restricted List prior to obtaining any security or other financial interest in an entity, but with the following proposed refinements:

- Requiring firm personnel to review the Restricted List, not only before they or their relevant family members<sup>192</sup> obtain a direct or material indirect financial interest in an entity or enter into a direct or material indirect relationship with an entity,<sup>193</sup> but also after changes to the list of restricted entities are communicated by the firm, upon firm personnel's employment at the firm, prior to changes in position (e.g.,

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<sup>189</sup> Firms would be required to communicate changes to the Restricted List. For periods where there were no changes, no such communication would be required.

<sup>190</sup> See Section IV.I.1.a.iv below for a discussion of the firm's responsibilities when it uses resources or services provided by a network or third-party provider.

<sup>191</sup> SECPS requirements use the term "professionals," which means professional staff, including partners. See SECPS § 1000.46 (requirement 1.a).

<sup>192</sup> Context determines which family members would be relevant. See, e.g., Regulation S-X Rule 2-01(f)(9), 17 C.F.R. § 210.2-01(f)(9) (defining "close family members"); Regulation S-X Rule 2-01(f)(13), 17 C.F.R. § 210.2-01(f)(13) (defining "immediate family members"); see generally Regulation S-X Rule 2-01(c), 17 C.F.R. § 210.2-01(c) (referring to "close family member" or "immediate family member" depending on the context).

<sup>193</sup> We are using the terms direct and material indirect investment in the same sense as Regulation S-X Rule 2-01(c), 17 C.F.R. § 210.2-01(c).

going into a chain of command or other covered person role<sup>194</sup>), and prior to entering into or modifying any business or employment relationships.

- Requiring the firm and firm personnel to take required actions on a timely basis if the review of the Restricted List indicates that action is required under applicable professional and legal requirements or the firm's policies and procedures.

Under the proposed approach, the firm's policies and procedures would also require that the Restricted List be reviewed before the firm enters into any relationship, engagement to perform non-audit services, or fee arrangement that might affect compliance with independence requirements. This requirement would serve the same purpose as review of the Restricted List by the firm personnel and would help the firm to identify relationships that may result in noncompliance with applicable professional or legal requirements.

## 2) Independence certifications

- e. Obtaining certifications from *firm personnel* regarding familiarity and compliance with SEC and PCAOB independence requirements and the firm's independence policies and procedures (1) upon employment, (2) at least annually thereafter, and (3) upon any change in personal circumstances, such as role, geographic location, or marital status, that is relevant to independence; and

Certifications are intended to drive greater accountability for firm personnel's compliance with independence requirements and to deter independence violations. The proposed certification requirement is similar to an existing SECPS requirement, which requires each professional to certify near the time of initial employment and at least annually thereafter that he or she (1) has read the member firm's independence policies, (2) understands their applicability to his or her activities and those of his or her spouse and dependents, and (3) has complied with the requirements of the member firm's independence policies since the prior certification.<sup>195</sup>

The proposed standard would not prescribe a checklist of specific content for the certifications, focusing instead on general concepts of familiarity and compliance. It is possible that the form of certification called for by the existing SECPS requirement would satisfy the proposed standard. In addition, the proposed standard expands on the existing SECPS requirement by requiring firms to obtain certifications every time firm personnel have a change

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<sup>194</sup> "Covered persons in the firm" is defined in Regulation S-X Rule 2-01(f)(11), 17 C.F.R. § 210.2-01(f)(11).

<sup>195</sup> See SECPS § 1000.46 (requirement 7.b).

in personal circumstances that is relevant to independence, such as a change in role, geographic location, or marital status. Changes within the firm such as promotions, moving offices, or changing practice groups may have consequences under independence rules (e.g., changes to covered person status) and result in noncompliance. Changes in family circumstances could also have that effect. Obtaining certification upon any change in personal circumstances that is relevant to independence would help prevent noncompliance by requiring firm personnel to reevaluate their personal independence.

### 3) Matters requiring audit committee pre-approval

#### f. Identifying matters that require audit committee pre-approval and obtaining such pre-approval.

Proposed QC 1000 contains a new requirement regarding firm policies and procedures for identifying matters that require pre-approval by the audit committee and obtaining such approval.

As discussed in the concept release, we were considering explicitly addressing controls over a firm's existing responsibilities for communications with audit committees regarding independence matters.<sup>196</sup> One firm stated that such controls are often a mix of firm-level and engagement-level processes, while another firm believed that such controls are ultimately the engagement team's responsibility. We agree that the primary responsibility for identifying matters that require audit committee pre-approval and obtaining such pre-approval resides at the engagement level. The firm's policies and procedures, however, can provide tools and guidance that enable engagement teams to properly identify the relevant matters and obtain necessary pre-approvals on a timely basis. Through our oversight activities, we have observed numerous instances where firms did not have an effective mechanism in place for monitoring whether matters that require audit committee pre-approval were properly disclosed to audit committees. We believe that the proposed new requirement should lead to more consistent compliance.

#### iii. Communication of changes to ethics and independence policies and procedures

.35 The firm must make available its ethics and independence policies and procedures to *firm personnel* and others performing work on behalf of the firm who are subject to ethics

<sup>196</sup> See, e.g., Regulation S-X Rule 2-01(c)(7), 17 C.F.R. § 210.2-01(c)(7); PCAOB Rule 3524; PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*.

and independence requirements, including communicating any substantive changes to such policies and procedures on a timely basis.

The proposed standard incorporates SECPS requirements regarding the dissemination of the firm's ethics and independence policies and procedures.

When deciding how to make ethics and independence policies and procedures available, firms would think about how to make firm personnel and others performing work on behalf of the firm aware of where and how to find these policies and procedures in a way that supports those individuals' ongoing compliance with certification and other requirements. The proposed standard would further require the firm to communicate any substantive changes to its ethics and independence policies and procedures on a timely basis.

iv. QC policies and procedures about mandatory ethics and independence training

.36 The firm must provide mandatory training to *firm personnel* near the time of initial employment and periodically (at least annually) thereafter that addresses ethics and independence requirements and the firm's ethics and independence policies and procedures.

The proposed standard includes a requirement for mandatory periodic training on ethics and independence, which incorporates the existing SECPS requirements. The proposed mandatory training requirement is intended to promote awareness and understanding of the ethics and independence requirements, which should lead to better compliance with such requirements. Under existing SECPS requirements, firms are required to establish a training program for professionals to complete near the time of initial employment and periodically thereafter.<sup>197</sup>

The specific content and extent and timing of the training would be determined by the firm, but the program would be required to cover both the relevant professional and legal requirements (for example, regarding financial interests, business relationships, employment relationships, proscribed services, and fee arrangements) and the firm's related policies and procedures.

By not specifying the content for such mandatory training, the proposed standard would allow firms the ability to develop training programs based on their circumstances. For example, a firm may develop its training to place a greater emphasis on areas with recurring ethics and

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<sup>197</sup> See SECPS § 1000.46 (requirement 3).

independence findings across the firm, or it may target specific ethics and independence findings in different regions. Similarly, the proposed standard does not specify how the firm would provide such training. A firm may develop and deliver its own training, contract with others to provide training, or provide access to third-party training.

Under the proposed standard, the firm would be required to provide such training at least annually, or more often as needed.

## 2. Current PCAOB standards

QC 20 provides that policies and procedures should be established to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.<sup>198</sup> The SECPS member requirements regarding independence quality controls apply only to certain firms. The proposed requirements for ethics and independence discussed above are more detailed than the existing requirements in QC 20 and Appendix L of the SECPS and would apply to all firms.

## 3. Key differences from other QC standards

The differences between our proposed requirements and other QC standards are:

- Proposed QC 1000 includes two additional quality objectives related to violations of ethics and independence requirements, focusing on their identification, evaluation, response, and communication. Other QC standards address violations of ethics and independence requirements as part of their specified responses.
- Proposed QC 1000's specified quality responses are tailored to the U.S. regulatory environment, including existing PCAOB ethics and independence standards and PCAOB and SEC independence rules, so they differ from the corresponding provisions of other QC standards. The provisions of ISQM 1 are focused on the *International Code of Ethics for Professional Accountants (including International Independence Standards)* of IESBA and the provisions of SQMS 1 are focused on the AICPA Code of Professional Conduct.

## Questions

26. Are the proposed quality objectives for ethics and independence requirements appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?

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<sup>198</sup> See QC 20.09.

27. Are the proposed specified quality responses for ethics and independence requirements appropriate? If not, what changes to the specified quality responses are necessary for this component?
28. Is the proposed specified quality response to have an automated process for identifying direct or material indirect financial interests appropriate? If not, why not? Is the proposed threshold (firms that issued audit reports with respect to more than 100 issuers during the prior calendar year) appropriate? If not, why not?
29. Is the proposed specified quality response related to communication of changes to the list of restricted entities at least monthly (and more frequently, if appropriate) to firm personnel and others performing work on behalf of the firm who are subject to independence requirements appropriate? Could communication to a more limited group accomplish the goal of alerting all individuals whose actions and relationships are relevant to independence? If so, to whom should changes be communicated?
30. In addition to the annual written independence certification, should the proposed standard require an annual written certification regarding familiarity and compliance with ethics requirements and the firm's ethics policies and procedures? Why or why not? Should firms be required or encouraged to adopt firm-wide codes of ethics or similar protocols? Why or why not? Are there other specific policies that QC 1000 should require or encourage to promote ethical behavior?

## G. Acceptance and Continuance of Client Relationships and Specific Engagements

This component addresses the firm's processes when considering whether to accept or continue a client relationship or specific engagement.

### 1. Proposed QC 1000

.37 This component addresses the firm's processes for making decisions about whether to accept or continue a client relationship or a specific *engagement*.

#### a. Acceptance and continuance of client relationships and specific engagements quality objectives

The proposed standard would require the firm to establish the following quality objectives:

.38 The *quality objectives* established by the firm with respect to the acceptance and continuance of client relationships and specific *engagements* should include the following:

- a. Judgments about whether to accept or continue a client relationship or specific *engagement* are:
  - (1) Made as part of or before performing preliminary *engagement* activities;
  - (2) Consistent with the firm's ability to perform the *engagement* in accordance with *applicable professional and legal requirements*, based on:
    - (a) Whether the firm is independent;
    - (b) Whether the services are permissible and any required audit committee pre-approval has been or will be obtained;
    - (c) The extent to which the firm is or will be able to gain access to client information to perform the *engagement*, including to client personnel who provide such information;
    - (d) The extent to which the firm has or can obtain resources to perform the *engagement*; and
    - (e) Other relevant factors associated with providing professional services in the particular circumstances; and
  - (3) Based on and supported by information about the nature and circumstances of the *engagement* and the integrity and ethical values of the client (including management and the audit committee).

Acceptance and continuance of client relationships and specific engagements is an aspect of a firm's compliance and risk management process. Each firm, depending on its nature and circumstances, may approach client acceptance and continuance differently. The client acceptance and continuance process may assist a firm in mitigating reputational, business, and litigation risk. The proposed quality objectives stress the importance of focusing the client acceptance and continuance process on the firm's ability to perform an engagement in accordance with applicable professional and legal requirements.

#### i. Timing

The firm's judgment about whether to accept or continue a client relationship should be made as part of or before performing preliminary engagement activities. Preliminary engagement activities, which are activities the auditor should perform at the beginning of the

audit, are described in paragraph .06 of AS 2101, *Audit Planning*. This quality objective aligns with the timing requirements under the auditing standards.

#### ii. Independence and permissibility of services

The firm's ability to perform the engagement includes considering whether the firm is independent and whether the services are permissible. These are threshold considerations for client acceptance and continuance, because under PCAOB standards the firm is not allowed to accept a client unless it is independent of that client and the services are permissible under applicable professional and legal requirements (including obtaining audit committee pre-approval where that is required).

The firm's policies for acceptance and continuance in the areas of independence, permissibility of services, and pre-approval would relate to and to some extent overlap with the ethics and independence component. The requirements in the ethics and independence component more generally address the ongoing evaluation of compliance with applicable professional and legal requirements relating to the independence of the firm, firm personnel, and others subject to such requirements.

#### iii. Access to client information and client personnel

The firm's ability to perform an engagement in accordance with applicable professional and legal requirements depends on the firm's ability to obtain information from the client and gain access to individuals at the client who can respond to the firm's inquiries. Restricted or limited access to client information or personnel—for example, due to language differences, physical location, or local law restrictions—could impair the firm's ability to perform the engagement in accordance with applicable professional and legal requirements.

#### iv. Resources

Another aspect of the firm's ability to complete the engagement in accordance with applicable professional and legal requirements is the resources available to the firm. It is important for a firm to have the right resources available so that the engagement can be performed in accordance with applicable professional and legal requirements. This may include the availability of resources like the following, either internal or external to the firm:

- Firm personnel or other participants with competence to perform procedures (e.g., industry experience or experience with new or specialized accounting pronouncements that apply to the client) and sufficient availability to meet audit timing requirements;
- Engagement partners;

- Specialists;
- EQRs;
- Technology to be used in the performance of the engagement, such as technology for testing the effective implementation of automated processes; and
- Intellectual resources needed in the performance of the engagement (e.g., industry specific audit programs).

#### v. Other relevant factors

The firm's ability to perform engagements in accordance with applicable professional and legal requirements also may be affected by other factors associated with providing professional services in the particular circumstances. Accordingly, the proposed standard, by directing firms to consider such other relevant factors, retains the breadth and inclusiveness of QC 20.15b, which requires the firm to establish policies and procedures to provide reasonable assurance that the firm appropriately considers the risks associated with providing professional services in the particular circumstances.

The concept release described a potential incremental provision for the consideration of risks associated with the engagement, which would require firms to identify matters that could significantly affect the conduct of the engagement and assess whether the firm can develop quality responses. Two firms asked if the firm would be required to perform initial planning, including risk assessment procedures, prior to accepting or continuing the client relationship. Under existing PCAOB standards, as well as proposed QC 1000, the determination of whether the firm can perform the engagement does not require the firm to perform risk assessment procedures for the engagement. In the proposed standard, a firm would need to consider all "relevant factors" while making judgments about the firm's ability to perform the engagement.

#### vi. Information about the nature and circumstances of the engagement, including the integrity and ethical values of the client

In order for the firm to make appropriate judgments about whether to accept or continue a client relationship, the firm would need to obtain sufficient information about the nature and circumstances of the engagement (e.g., the nature of the entity and the environment in which it operates) and the integrity and ethical values of the client, including its management and audit committee.<sup>199</sup> This information is relevant because it can help identify potential risks to performing the engagement that may result in the firm not being able to

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<sup>199</sup> For a prospective engagement, this includes evaluating information obtained from a predecessor firm. *See generally, e.g., AS 2610, Initial Audits—Communications Between Predecessor and Successor Auditors.*

perform the engagement in accordance with applicable professional and legal requirements. The nature and circumstances of the engagement may, for example, reveal the need for specialized expertise that the firm does not have. A lack of management integrity may affect the reliability of the company's accounting records. Designing and implementing policies and procedures that direct and standardize the collection and evaluation of such information could help the firm in consistently making appropriate judgments about whether to accept or continue a client relationship. Additionally, information obtained during the firm's acceptance and continuance process about the nature and circumstances of the engagement and the integrity of management and the audit committee would in many cases be relevant when planning and performing the engagement.<sup>200</sup>

b. The terms of the *engagement*, including the objective of the *engagement* and responsibilities of the firm and management, are consistent with *applicable professional and legal requirements*, and are understood by the firm and the client.

This quality objective retains the concept in QC 20.16 of having policies and procedures regarding obtaining an understanding with the client about the engagement and aligns with similar requirements under our auditing and attestation standards.<sup>201</sup> Achieving this objective should minimize the risk of misunderstandings regarding the nature and scope of the engagement and any limitations associated with it.

**b. Acceptance and continuance of client relationships and specific engagements specified quality responses**

The proposed standard includes a specified quality response regarding policies and procedures to address situations where the firm learns of information that would have caused it to decline a previously accepted engagement.

.39 In designing and implementing *quality responses* to address the *quality risks* in the acceptance and continuance of client relationships and specific *engagements* component, the firm should include the specified *quality response* in paragraph .40. This specified *quality response* alone will not be sufficient to enable the firm to achieve all established *quality objectives* for this component. Depending on the *quality risk* being addressed, specified

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<sup>200</sup> See, e.g., paragraphs .41-.45 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

<sup>201</sup> See paragraph .05 of AS 1301, *Communications with Audit Committees* and paragraph .46 of AT 101.

*quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

.40 The firm should establish policies and procedures to address situations in which the firm becomes aware of information subsequent to accepting or continuing a client relationship or specific *engagement* that could have caused the firm to decline such relationship or *engagement* had that information been known prior to acceptance or continuance.

Under this proposed specified quality response, the firm's policies and procedures would have to address situations in which the firm becomes aware of relevant contrary information after the firm's decision to accept or continue a client relationship or specific engagement. For purposes of the proposed standard, the firm is "aware" of information if any partner, shareholder, member, or other principal of the firm is aware of such information.<sup>202</sup>

This information may have existed at the time of the decision to accept or continue a client relationship or specific engagement but not been known by the firm at the time, or it may have emerged subsequent to that decision. Depending on the circumstances, appropriate responses may include such actions as:

- Consulting with legal counsel or others within the firm to determine if the firm is able to continue the relationship;
- Discussing the information with management and the audit committee to determine if the firm is able to continue the relationship;
- Including this information in the auditor's risk assessment procedures so that any additional risks are responded to during the audit; and
- Withdrawing from the engagement and notifying appropriate regulatory authorities as required under applicable professional and legal requirements.

Some firms indicated that in these situations a variety of actions may be appropriate based on the risk; however, they did not elaborate on what actions could be taken. The concept release referenced ISQM 1 provisions that mention that withdrawal from the engagement may be an appropriate action, and the same firms indicated that a firm should not automatically be

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<sup>202</sup> This approach aligns with the instructions to Form 3, under which a firm is deemed aware of reportable facts on the first day that any partner, shareholder, principal, owner, or member of the firm first becomes aware of the facts. See Form 3, Note to Instructions to Part II.

required to withdraw from the engagement. Proposed QC 1000 is not prescriptive as to what actions a firm should take upon becoming aware of such information.

## 2. Current PCAOB standards

The quality objectives of proposed QC 1000 paragraph .38 would not fundamentally change a firm's existing responsibilities regarding acceptance and continuance decisions under QC 20.<sup>203</sup> The quality objectives would expand on the requirements in QC 20 with regard to considering the necessary information and making appropriate judgments about the associated risks and the firm's ability to mitigate those risks and perform an engagement in accordance with applicable professional and legal requirements.

## 3. Key differences from other QC standards

Other QC standards include a specified response that the firm establish policies or procedures that address circumstances when the firm is obligated by law or regulation to accept a client relationship or a specific engagement. Proposed QC 1000 does not include a similar provision because this situation would not arise under SEC or PCAOB rules.

### Questions

31. Are the proposed quality objectives for acceptance and continuance of client relationships and specific engagements appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?
32. Are the proposed specified quality responses for acceptance and continuance of client relationships and specific engagements appropriate? If not, what changes to the specified quality responses are necessary for this component?

## H. Engagement Performance

This component addresses the firm's processes relating to the performance of the firm's engagements in accordance with applicable professional and legal requirements.

### 1. Proposed QC 1000

.41 This component addresses the firm's processes relating to the performance of the firm's *engagements* by *firm personnel* and *other participants* in accordance with *applicable professional and legal requirements*.

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<sup>203</sup> See QC 20.14-.16.

Engagement performance encompasses the activities of firm personnel and other participants in all phases of the design and execution of the engagement—planning, performing, supervising, documenting, and communicating the results of the engagement, as well as conducting an engagement quality review.<sup>204</sup> In order for the firm to consistently deliver compliant engagements, including work performed on other firms' engagements, firm personnel and other participants need to understand and fulfill responsibilities in accordance with applicable professional and legal requirements. The proposed standard includes quality objectives related to specific aspects of engagement performance.

Under proposed QC 1000, a firm would be required to establish quality objectives for the engagement performance component in the following areas:

- Engagement responsibilities;
- Consultations and differences in professional judgment; and
- Engagement documentation.

**a. Engagement responsibilities**

.42 The *quality objectives* established by the firm with respect to the performance of its *engagements*, including work performed on other firms' *engagements*, should include the following:

- a. Responsibilities are understood and fulfilled by *firm personnel* and *other participants* in accordance with *applicable professional and legal requirements*, including, as applicable:
  - (1) The responsibilities of the engagement partner for an *engagement* and its performance;
  - (2) Responsibilities for planning and performing the *engagement*, including:
    - (a) Exercising due professional care, including professional skepticism, such that conclusions reached are appropriate under *applicable professional and legal requirements* and supported by sufficient appropriate evidence; and
    - (b) Properly supervising the work performed by *firm personnel* and *other participants*; and

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<sup>204</sup> See QC 20.18.

(3) Responsibilities for reporting and other communications with respect to the engagement.

i. Responsibilities of the engagement partner

The engagement partner is responsible for managing and achieving consistent compliance with applicable professional and legal requirements on the engagement. This quality objective is intended to focus firms on partner involvement throughout the engagement, including appropriately supervising firm personnel and other participants.<sup>205</sup>

ii. Due professional care

Due professional care means acting with reasonable care and diligence and exercising professional skepticism, such that conclusions reached are appropriate under applicable professional and legal requirements. Professional skepticism is an attitude that includes a questioning mind and critical assessment of audit evidence.<sup>206</sup> Exercising professional skepticism improves the quality of judgments made while performing the engagement and is key to performing an engagement in good faith and with integrity. Our oversight activities have suggested that the lack of professional skepticism contributes to some of the QC deficiencies identified during PCAOB inspections.<sup>207</sup> In one example, a firm's policies and procedures did not provide reasonable assurance that engagement partners supervised engagements with due professional care, which contributed to the failure to identify deficiencies in those engagements.

The concept release included a question about whether a new QC standard should expressly address the firm's responsibilities and actions to support and monitor appropriate application of professional skepticism and significant judgments made by the engagement team. Commenters, including firms and related groups, generally opposed requirements that would be incremental or alternative to the provisions in ISQM 1. Several argued that the approach in ISQM 1 was adequate.<sup>208</sup> Other firms suggested that requirements related to

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<sup>205</sup> See generally, e.g., AS 1201, *Supervision of the Audit Engagement*.

<sup>206</sup> See paragraph .07 of AS 1015, *Due Professional Care in the Performance of Work*, and paragraph 6. of AT No. 1.

<sup>207</sup> See, e.g., *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers*, PCAOB Release No. 2020-001 (Aug. 20, 2020), at 21.

<sup>208</sup> The most relevant provision in ISQM 1 is a requirement to establish a quality objective that "[e]ngagement teams exercise appropriate professional judgement and, when applicable to the type of engagement, professional skepticism." ISQM 1.31(c).

professional skepticism and significant judgments should not be part of QC standards, but rather considered within the auditing standards. One firm suggested that the PCAOB provide examples of appropriate application of professional skepticism and how to monitor judgments. One professional association agreed that requirements to support and monitor the application of professional skepticism should be expressly included in a QC standard, including requirements for documenting the exercise of professional skepticism.

We propose to include a quality objective related to due professional care, including professional skepticism, that enables appropriate conclusions to be reached that are supported by sufficient appropriate evidence.

### iii. Supervision

Proper supervision aims to ensure that work is performed as directed and supports the conclusions reached.<sup>209</sup> The proposed quality objective emphasizes the importance of firm personnel and other participants being supervised properly, consistent with AS 1201, , and AT No. 1.

### iv. Reporting and other communications

PCAOB standards and rules impose a number of requirements relating to reporting and communicating the results of the engagement.<sup>210</sup> The engagement report and communications to the audit committee are typically prepared at the engagement level and may include information provided by the firm. For example, the firm may provide information related to independence to be communicated in accordance with PCAOB Rule 3524 or PCAOB Rule 3526. This quality objective emphasizes the importance of auditor reporting and communication in accordance with applicable requirements.

#### b. Consultations and differences in professional judgment

b. Consultations on complex, unusual, or unfamiliar accounting and auditing matters are undertaken with qualified individuals from within or outside the firm, and conclusions are:

- (1) Agreed to by the engagement partner and the parties consulted;
- (2) In accordance with *applicable professional and legal requirements*; and

<sup>209</sup> See paragraph .02 of AS 1201, *Supervision of the Audit Engagement*.

<sup>210</sup> See generally, e.g., AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*; AS 1301; paragraphs .34-.38 of AT No. 1; and AT 101.63-.90.

(3) Implemented before the issuance of the *engagement* report.

- c. Differences in professional judgment related to the *engagement* that arise among *firm personnel*, among *other participants*, or between *firm personnel* and *other participants*, including the engagement quality reviewer or those that provide consultation, are brought to the attention of the individual(s) with responsibility and authority for resolving such matters and are resolved before the issuance of an *engagement* report, such that the *engagement* is performed in accordance with *applicable professional and legal requirements*.

Consultations are an important aspect of engagement performance, as they provide a mechanism to discuss and resolve complex, unusual, or unfamiliar matters with individuals who have the requisite knowledge, skill, and ability. Under our current standards, QC 20.19 highlights the significance of consultations, requiring appropriate policies and procedures. The proposed quality objective would be intended to drive firms to continue to focus on the importance of consultation and resolution before the issuance of an engagement report.

Differences in professional judgment may occur when there is a concern or disagreement regarding the application of applicable professional and legal requirements during the performance of the engagement. The proposed quality objective would underscore the importance of having and adhering to appropriate procedures for the resolution of differences in professional judgment during the performance of engagements such that the firm, firm personnel, and other participants comply with applicable professional and legal requirements.

**c. Engagement documentation**

- d. *Engagement* documentation is prepared, reviewed, assembled, and retained in accordance with *applicable professional and legal requirements*.

AS 1215 contains the general requirements for documentation the auditor should prepare and retain in connection with engagements. Regulation S-X Rule 2-06 also addresses documentation retention requirements.<sup>211</sup> The proposed quality objective regarding engagement documentation in proposed QC 1000 is meant to drive firms to focus on compliance with these requirements.

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<sup>211</sup> Regulation S-X Rule 2-06, 17 C.F.R. § 210.2-06.

## 2. Appendix K requirements

Existing PCAOB standards (referred to as Appendix K requirements) require SECPS member firms that are associated with international firms or networks to seek adoption by their associated international firms or network of policies and procedures regarding filing reviews, inspection procedures, and disagreements between the engagement partner and the reviewer.<sup>212</sup>

The concept release asked whether we should retain these requirements, whether they should be changed and extended to all foreign firms, and whether the responsibilities of the reviewer are clear. Commenters were split regarding the retention and scope of Appendix K requirements. Some firms and a related group asserted that the Appendix K requirements add value and should not only be retained but also extended to all non-U.S. firms. Other firms stated that the requirements should not be retained in their current form. Some firms suggested that ISQM 1's risk-based approach would be more appropriate. A couple of commenters requested clarity on the responsibilities of the reviewer compared to the engagement quality reviewer.

At the time the SECPS issued the Appendix K requirements, foreign private issuers ("FPIs")<sup>213</sup> were required to reconcile financial statements prepared under another basis of accounting to U.S. generally accepted accounting principles ("U.S. GAAP"). This reconciliation was an area of focus in the filing reviews by the SECPS member firms under Appendix K. Several years after the Appendix K requirements were issued, the SEC adopted rules that allow FPIs to file financial statements prepared under International Financial Reporting Standards as issued by the International Accounting Standards Board without reconciliation to U.S. GAAP.<sup>214</sup> In addition, AS 1220, *Engagement Quality Review*, has been implemented, under which an EQR is required for all engagements.

We believe that the purposes originally intended to be served by Appendix K may have either been eliminated (through the elimination of the U.S. GAAP reconciliation) or otherwise addressed (through requirements for engagement quality review). Accordingly, we do not propose to retain requirements like those in Appendix K as required quality objectives or

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<sup>212</sup> See SECPS § 1000.08(n) (cross-referencing the objectives set forth in Appendix K, SECPS § 1000.45). The types of SEC filings subject to review under Appendix K are registration statements, annual reports on Form 20-F and Form 10-K, and other filings that include or incorporate the foreign associated firm's audit report on the financial statements of an SEC registrant.

<sup>213</sup> "Foreign private issuer" is defined in Rule 405 of Regulation C, 17 C.F.R. § 230.405, under the Securities Act of 1933 and in Rule 3b-4, 17 C.F.R. § 240.3b-4, under the Exchange Act.

<sup>214</sup> See *Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP*, SEC Exchange Act Release No. 57026 (Dec. 21, 2007).

specified quality responses. However, under the risk-based approach we are proposing, firms would have to assess and respond to quality risks including, if applicable, a relative lack of experience in performing engagements under the legal and professional requirements that apply to audits of U.S. public companies. For some firms, the response to that risk might involve adding another member to the engagement team who possesses the necessary experience in applying applicable professional and legal requirements.

### **3. Auditor’s responsibilities under Section 10A**

The concept release sought comment on whether our QC standard should expressly address a firm’s actions to support the fulfillment of the auditor’s responsibilities under Section 10A of the Exchange Act.<sup>215</sup> Firms and related groups generally opposed including in our QC standard provisions that are incremental to ISQM 1 to expressly address those responsibilities. Some pointed out that these requirements already exist in auditing standards, and others argued that the provisions of ISQM 1 would be adequate. As proposed, the auditor’s responsibilities under Section 10A are part of “applicable professional and legal requirements,” and would therefore be addressed throughout proposed QC 1000.

### **4. Current PCAOB standards**

Under current QC standards, engagement performance covers all phases of the design and execution of the engagement, and engagement quality reviews.<sup>216</sup> QC 20 contains general requirements regarding engagement performance, including planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement; referring to authoritative literature; and consulting with qualified individuals when appropriate. QC 20 provides that policies and procedures should be established to provide reasonable assurance that the engagement is performed in accordance with applicable professional standards. Proposed QC 1000 retains these concepts from the extant standards.

### **5. Key differences from other QC standards**

Proposed QC 1000 includes a quality objective in paragraph .42a.(3) related to the responsibilities for reporting and other communications with respect to the engagement, which does not appear in the other QC standards. It would retain a concept currently included in existing PCAOB quality control standards.

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<sup>215</sup> See Section 10A of the Exchange Act, 15 U.S.C. § 78j-1.

<sup>216</sup> See QC 20.18.

## Questions

33. Are the proposed quality objectives for engagement performance appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?

34. Should we include specified quality responses for the engagement performance component? If so, what should they be?

35. We are proposing to eliminate the current Appendix K requirement and rely exclusively on a risk-based approach. Should the standard include specified quality responses explicitly directed to non-U.S. firms that audit issuers? If so, what are they?

### I. Resources

This component addresses the firm's responsibilities for obtaining, developing, using, maintaining, allocating, and assigning resources—including people, financial, technological, and intellectual resources—to enable the design, implementation, and operation of the firm's QC system and the performance of its engagements.

#### 1. Proposed QC 1000

.43 This component addresses the firm's processes for obtaining, developing, using, maintaining, allocating, and assigning the firm's resources to enable the design, implementation, and operation of the firm's QC system and the performance of its *engagements*. The firm's resources include people, financial, technological, and intellectual resources, and resources from a network or *third-party provider*.

##### a. Resources quality objectives

Under proposed QC 1000, a firm would be required to establish quality objectives for the resources component in several different areas:

- People;
- Financial resources;
- Technological resources;
- Intellectual resources; and
- Resources from a network or third-party provider.

### i. People

.44 The *quality objectives* established by the firm with respect to the firm's resources should include the following:

- a. *Firm personnel* are hired, developed, and retained who have the competence to perform activities and carry out responsibilities for the operation of the firm's QC system and the performance of the firm's *engagements* in accordance with *applicable professional and legal requirements* and the firm's policies and procedures.

Note: Competence consists of having the knowledge, skill, and ability that enable individuals to act in accordance with *applicable professional and legal requirements* and the firm's policies and procedures. The measure of competence is qualitative rather than quantitative because quantitative measurement may not accurately reflect the experience gained by *firm personnel* over time.

- b. *Firm personnel* demonstrate a commitment to quality through (1) their actions and behaviors and (2) development and maintenance of the competence to perform their roles.

These quality objectives are similar to the personnel management element of quality control addressed in QC 20 and QC 40. The proposed standard includes a note that describes what competence comprises—knowledge, skill, and ability—which is derived from QC 40.04. As under QC 40, competence under proposed QC 1000 would be a qualitative measure and not a quantitative measure based solely on years of experience.<sup>217</sup> These two quality objectives work together in addressing competence from the perspective of both the firm and individual. The firm and its personnel have responsibilities for developing and maintaining competence that will support the operation of the firm's QC system and the performance of the firm's engagements in accordance with applicable professional and legal requirements and the firm's policies and procedures.

Understanding the competence needed to carry out responsibilities for the operation of the firm's QC system and the performance of the firm's engagements assists a firm in identifying its personnel needs. This understanding also assists a firm in identifying areas for personnel development. Competence can be developed through an appropriate combination of

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<sup>217</sup> See QC 40.04 (competencies are not measured by periods of time because such quantitative measurement may not accurately reflect the kinds of experiences gained by firm personnel in any given time period).

education, professional experience in accounting and auditing with proper supervision, obtaining professional licenses, and training such as CPE.

A commitment to quality can be demonstrated through a person's actions and behaviors, including consistent adherence to firm policies and procedures, demonstrating key professional attributes like objectivity, integrity, and due professional care, and taking the initiative to develop and maintain competence. Conversely, a lack of commitment to quality can be seen through actions and behaviors such as inconsistent compliance with professional standards, cheating on professional development and compliance exams, or a "check the box" approach to professional development.

Notably, while most of the proposed quality objectives in QC 1000 target compliance with applicable professional and legal requirements, most of the proposed quality objectives in the Resources component also look to compliance with firm policies and procedures. These quality objectives function in a slightly different way than most of the proposed quality objectives in QC 1000. The firm's resources need to be deployed in compliance with firm policies and procedures in order for the system to operate as designed and achieve its objectives because the QC system is based on designing and implementing policies and procedures to address quality risks. Quality objectives that refer to compliance with firm policies and procedures are intended to direct the firm to measure whether its responses to quality risks are operating as designed.

- c. Individuals who are assigned to *engagements*, including the engagement partner and engagement quality reviewer, have the competence, objectivity, and time to fulfill their responsibilities on such *engagements* in accordance with *applicable professional and legal requirements* and the firm's policies and procedures.
- d. *Firm personnel* who are assigned to participate in another firm's *engagement* have the competence, objectivity, and time to perform such activities in accordance with *applicable professional and legal requirements* and the firm's policies and procedures.
- e. Individuals who are assigned to perform activities within the QC system have the competence, objectivity, authority, and time to perform such activities in accordance with *applicable professional and legal requirements* and the firm's policies and procedures.

These quality objectives address the assignment of individuals, both firm personnel and other participants, in the firm's engagements and QC roles and other firms' engagements. As discussed in Section III.B, the firm's people resources may include personnel employed by the firm (firm personnel) or resources contracted from outside the firm (other participants). For

example, EQRs or personnel at service centers may be considered either firm personnel (if employed by the firm) or other participants (if contracted by the firm).

The quality objectives focus on three key aspects of the ability to fulfill the assigned role: competence, objectivity, and time. Individuals need to have competence to fulfill their assigned roles in accordance with applicable professional and legal requirements and the firm's policies and procedures. As previously discussed, both the individual and the firm play a part in developing a person's competence. The ability to maintain objectivity is essential to performing QC activities or engagements; a lack of objectivity may, for instance, create an unconscious bias that directly affects quality. Individuals' ability to devote appropriate time to their assignments also affects quality.

The concept release also included a question regarding placing greater emphasis on firm personnel having sufficient time to properly carry out their engagement and QC roles. Many firms and related groups responded that the emphasis in ISQM 1 is sufficient and additional emphasis would not be required. Two commenters supported additional emphasis on sufficient time in the proposed standard. Our preliminary view is that the proposed provision regarding sufficient time to carry out engagement and QC roles, which aligns with ISQM 1, would provide adequate direction, and we are not proposing incremental requirements beyond that.

In addition to the competence, objectivity, and time that are important for performing engagement and QC activities, individuals need to have the requisite authority to perform effectively. In the context of engagement activities, the auditing standards already provide authority structures with respect to, for example, supervision and the responsibilities of the engagement partner, and those standards are augmented by firm policies on matters such as consultation. For QC activities, we propose to specify the need for appropriate authority in the quality objective.

- f. *Firm personnel* comply with the firm's policies and procedures related to the operation of the firm's QC system and the performance of its *engagements* and the work performed on other firms' *engagements*.

This proposed quality objective is based on a concept embedded in QC 20: that firm personnel should adhere to the firm's own standards of quality. We believe that this should remain among the firm's objectives, and also that it would play an imperative role in the operation of the QC system under proposed QC 1000.

The firm's QC-related policies and procedures are essential to the proper functioning of an effective QC system. By definition, those policies and procedures are the "quality responses" the firm has designed and implemented to address quality risks. Firm personnel need to understand those policies and procedures and operate in compliance with them in order for the

QC system to operate as designed and achieve its objectives. Additionally, firm personnel need to understand and comply with firm policies and procedures in order for the firm's work on its own engagements and other firms' engagements to be performed appropriately.

- g. *Firm personnel* are (1) evaluated at least annually, (2) incentivized to fulfill their assigned responsibilities and adhere to appropriate standards of conduct, and (3) held accountable for their actions and failures to act.

Evaluations help support and promote the continuous development of the competence of firm personnel. Our proposed quality objective contemplates that evaluations would be performed at least annually. Many firms currently utilize an annual performance review process in order to facilitate such evaluations. Formal methods may include a comprehensive framework to evaluate firm personnel, but the proposed quality objective does not specify the format of or approach to periodic evaluations. Less formal methods of evaluation may also be used.

The concept release sought comment regarding expressly addressing how the firm's incentive system, including compensation, incorporates quality considerations. Some commenters argued that it would not be necessary for a proposed standard to address a firm's incentive system. Two commenters supported expressly addressing incentive systems. Many firms and a related group advocated a principles-based approach, such as in ISQM 1. The quality objective in proposed QC 1000, which refers to accountability and incentives, is principles-based, and firms would be able to design and implement incentive systems based upon their nature and circumstances. The "appropriate standards of conduct" identified in the quality objective would include fulfilling engagement and QC responsibilities with competence, integrity, objectivity, and due professional care and complying with applicable professional and legal requirements and the firm's policies and procedures, as described in paragraph .46 of the proposed standard.

#### ii. Technological resources

- h. Technological resources are obtained or developed, implemented, maintained, and used to enable the operation of the firm's QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements* and the firm's policies and procedures.

Note: Technological resources generally include information technology applications, infrastructure, and processes.

Technological resources cover many aspects that collectively comprise a firm's technological environment, including information technology applications, infrastructure, and processes (e.g., firm processes to manage access to the IT environment, program changes, changes to the IT environment, or IT operations). Technological resources may be developed by the firm or obtained, for example, from the firm's network or a third-party provider.

The nature and extent of the use of technological resources differs across firms. For example, some audit firms are making significant investments in technological resources and expanding their use of technology-based audit tools, such as software used to perform data analytics or to access information from a distributed ledger. Some technology facilitates the operation of firms' QC systems, such as monitoring individual financial investments for purposes of compliance with independence rules. The availability of "off-the-shelf" technological resources continues to evolve, leading to an increase in firms of all sizes employing technology to assist in operating their QC systems or planning and performing engagements.

This objective highlights that the proper use of technological resources, in a manner that enables the operation of the firm's QC system and the performance of its engagements in accordance with applicable professional and legal requirements and the firm's policies and procedures, is the firm's responsibility.

The concept release included a discussion about firms' use of emerging technology in performing engagements and in relation to QC activities, and asked whether a future QC standard should expressly address the use of technology in these areas. Many commenters, including firms and related groups, supported having the standard generally address at least some aspects of the use of emerging technology. Some commenters suggested that principles-based requirements, like those provided in ISQM 1, would be preferable, including because they would better accommodate future technological developments. Some commenters recommended that the standard focus on one or more of the following areas:

- Cybersecurity, risks of unauthorized access, and safeguarding of client information;
- Technology developed internally or by third parties used in the performance of engagements; and
- Automated intelligence and data analytics.

Many firms and related groups opposed including specific incremental provisions to address the prevention of unauthorized access to technology and data, while several other commenters supported such incremental provisions. One firm stated more broadly that the standard should not expressly address the use of emerging technology, but instead firms should be able to develop a risk management approach based on their own risk assessments.

The technology environment is dynamic, and firms' use of technological resources will likely continue to evolve in the future. We believe that principles-based standards would be more adaptable to future developments and less likely to discourage the use of emerging technologies. As a result, proposed QC 1000 does not include any prescriptive requirements specifically related to how firms address emerging technology. Instead, we included a risk factor to prompt consideration of technology as part of the firm's risk assessment process.<sup>218</sup>

The Board has an ongoing research project assessing the need for guidance, changes to PCAOB standards, or other regulatory actions in light of the increased use of technology-based tools by auditors and preparers.<sup>219</sup> We will continue to consider the implications for QC and other Board standards in the context of that project.

### iii. Intellectual resources

- i. Intellectual resources are obtained or developed, implemented, maintained, and used to enable the operation of the firm's QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements* and the firm's policies and procedures.

Note: Intellectual resources generally include resources that a firm makes available, or requires the use of, in the performance of its *engagements*, including, for example, the firm's policies and procedures, methodologies, guides, practice aids, and standardized documentation templates.

Intellectual resources generally include the information the firm uses to promote consistency in the execution of the firm's QC system and performance of engagements. Intellectual resources may be made available through technological resources (e.g., the firm's methodology may be embedded in the information technology application that facilitates the planning and performance of the engagement).

Intellectual resources may be obtained or developed internally, or acquired externally (for example, a commercially available audit or QC methodology or a subscription data feed). Regardless of how intellectual resources are acquired, the firm remains responsible for ensuring they are fit for purpose and properly implementing and maintaining them. For example, if a firm acquired its QC methodology from a vendor, the firm would be responsible for choosing a

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<sup>218</sup> See paragraph .20a.(1)(d) and Appendix B paragraph .B5 of QC 1000.

<sup>219</sup> More information about our Data and Technology research project is *available at* <https://pcaobus.org/oversight/standards/research-standard-setting-projects/changes-use-data-technology-conduct-audits>.

methodology and implementing it (including appropriately identifying risks and designing, implementing and operating appropriate responses) in a way that enabled the firm's engagements to be properly performed and the firm's QC system to operate in accordance with QC 1000. If a firm developed methodology to direct the performance of its engagements in accordance with applicable professional and legal requirements, and a new auditing standard were issued after that methodology was implemented by the firm, the methodology would need to be updated to be consistent with the applicable professional and legal requirements and the firm's policies and procedures.

The quality objective related to intellectual resources is similar to the technological resources quality objective, as both objectives relate to resources enabling the operation of the firm's QC system and the performance of its engagements in accordance with applicable professional and legal requirements and the firm's policies and procedures.

#### iv. Resources from a network or third-party provider

- j. If the firm belongs to a network that provides or requires the use of network resources or services or if the firm obtains resources or services from a *third-party provider*:
- (1) An understanding is obtained of how such resources or services are developed and maintained; and
  - (2) Such resources or services are supplemented or adapted as necessary such that their use enables the operation of the firm's QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements* and the firm's policies and procedures.

In some circumstances, the firm may use resources provided by a network or a third-party provider. Such resources may include methodologies, applications, and tools used in the firm's QC system or the performance of its engagements. Notwithstanding that a firm may use resources from a network or a third-party provider, the firm remains responsible for the use of these resources in the QC system and performance of the engagements.

Consideration of the nature of the resources provided by the network or third-party providers, how and to what extent the resources will be used, and the general characteristics of the third-party provider would assist the firm in determining whether it needs to supplement or adapt such resources. For example, the firm may obtain its methodology from a third-party provider under an arrangement whereby the third-party provider agrees to update the methodology when new standards are issued. In this scenario, the firm would remain responsible for verifying that such changes are incorporated into the methodology and supplementing the methodology if such changes are not made, so that the firm's resources

support its performance of compliant engagements. As another example, the firm may obtain a service from a third-party provider that provides a System and Organization Controls 1 (SOC 1) report. The firm would be responsible for verifying that the controls are designed effectively at the third-party provider and for designing and implementing any complementary user entity controls identified in the report.

The firm would also be responsible for taking any necessary actions in using a resource from a network or third-party provider to enable the resource to function effectively. For example, the network or third-party provider may need information related to the firm's restricted entities so that it can facilitate independence confirmations. In addition, if the firm discovered a problem with the design or operation of the resource, it may need to communicate such problems to the network or third-party provider so that the resource can effectively operate.

#### **b. Resources specified quality responses**

.45 In designing and implementing *quality responses* to address the *quality risks* in the resources component, the firm should include the specified *quality responses* in paragraphs .46 -.51. These specified *quality responses* alone will not be sufficient to enable the firm to achieve all established *quality objectives* for this component. Depending on the *quality risk* being addressed, specified *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

We are proposing several specified quality responses in the Resources component. These are generally intended to carry provisions from our existing QC standards into proposed QC 1000.

.46 The firm should design, implement, and maintain policies and procedures for *firm personnel* to adhere to appropriate standards of conduct, which include:

- a. Fulfilling *engagement* and QC responsibilities with competence, integrity, objectivity, and due professional care; and
- b. Complying with *applicable professional and legal requirements* and the firm's policies and procedures.

The reference to "appropriate standards of conduct" reflects a number of concepts in existing PCAOB standards, including:

- Fulfilling responsibilities with professional competence;<sup>220</sup>
- Integrity and objectivity;<sup>221</sup>
- Due professional care (including the exercise of professional skepticism);<sup>222</sup> and
- Complying with applicable professional and legal requirements and the firm's policies and procedures.<sup>223</sup>

Firm personnel are individually responsible for complying with the firm's standards of conduct, and the firm's policies and procedures around these standards of conduct are intended to result in firm personnel being held accountable for their behavior and actions. This includes evaluating firm personnel's adherence to such standards of conduct, addressing deviations, and holding personnel accountable for fulfilling their engagement and QC responsibilities, including through the firm's incentive system. Some firms and related groups expressed concern about having the standard specify responsibilities that would apply to all firm personnel, with one such firm requesting clarification of the scope and suggesting limiting the scope to all engagement personnel. However, we believe the standards of conduct included in this specified quality response are foundational to fulfilling not only engagement responsibilities, but also QC responsibilities.

.47 The firm should design, implement, and maintain policies and procedures for the engagement partner and, commensurate with their responsibilities, others participating in an *engagement* to obtain and maintain the competence to fulfill their respective assigned *engagement* roles, including an understanding of the following:

- a. The importance of exercising sound judgment, including the ability to be objective and exercise professional skepticism;
- b. The role of the firm's QC system in the performance of its *engagements* (e.g., engagement quality reviews, consultation process);
- c. Their responsibilities with respect to the performance and supervision of the *engagement*;

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<sup>220</sup> See, e.g., QC 20.13a, .13b, and .15a.

<sup>221</sup> See, e.g., QC 20.10.

<sup>222</sup> See generally AS 1015.

<sup>223</sup> See, e.g., QC 20.03.

- d. For attestation *engagements*, the subject matter of the assertion on which the *engagement* is based;
- e. The industry in which the client operates and its relevant characteristics (e.g., applicable standards, industry-specific risks, and industry-specific estimates);
- f. The internal control framework used by the client;
- g. The use of technology by the client in the preparation of its financial statements and related internal controls; and
- h. The use of technological and intellectual resources in performing *engagement* procedures, including obtaining and evaluating evidence.

QC 40 addresses requirements regarding the competencies of engagement partners and, by extension, EQRs.<sup>224</sup> That standard requires that firms' QC policies and procedures address certain enumerated competencies, as well as other competencies as necessary in the circumstances.

The concept release discussed these requirements and other potential requirements regarding competencies that we were considering adding to a new QC standard, including an understanding of the internal control framework used by the company and of the technology used in obtaining or evaluating audit evidence. The concept release also noted that we were considering expanding competency requirements beyond the engagement partner and EQR to others in engagement roles.

Many commenters supported the inclusion of engagement partner competency requirements. Some firms suggested that, in general, competency requirements should be based on a principles-based approach. Some supported the additions described in the concept release, while others argued that the competency requirements in existing PCAOB QC standards were sufficient. Some firms and a related group suggested that the engagement partner competency requirements should follow ISQM 1 requirements. One firm suggested that engagement partner competencies should be aligned with the learning outcomes specified in the standards of the International Accounting Education Standards Board.<sup>225</sup> Three firms sought clarification on the engagement partner's competency related to understanding technology.

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<sup>224</sup> See, e.g., QC 40.08; AS 1220.05.

<sup>225</sup> See *International Education Standard 8, Professional Competence for Engagement Partners Responsible for Audits of Financial Statements (Revised)*, Table A (Oct. 2019).

One firm questioned whether the idea of a single engagement partner taking responsibility for the entire audit was still realistic.

Some commenters supported adding competency requirements for others in engagement roles and for individuals in QC roles. Three commenters argued that requirements related to competencies of other individuals should not extend beyond current requirements or the provisions in ISQM 1. Other firms argued that the standards should not include competency requirements for individuals in other roles.

Proposed QC 1000 does not include incremental requirements regarding competencies for individuals in QC roles, as we believe the general provisions of the proposed standard may be sufficient. Paragraph .47 of proposed QC 1000 both expands the required competencies for engagement partners and requires certain competencies for others in engagement roles commensurate with their responsibilities. This includes applying existing requirements for engagement partners—an understanding of, among other things, the importance of exercising sound judgment, the role of the firm’s QC system in the performance of engagements, and the industry in which the client operates—to everyone in an engagement role, at a level commensurate with their responsibilities.

To reflect changes in the environment since the existing QC standards were issued, we are proposing required competencies related to understanding the subject matter of attestation engagements, the internal control framework and technology used by the client, and the technological and intellectual resources used in performing engagement procedures. Regarding technological and intellectual resources, we are proposing as a required competency an understanding of how and whether it is appropriate to use these resources in performing the engagement. This specified quality response is not intended to imply that the engagement partner or others participating on an engagement would be knowledgeable about how such resources are developed.

.48 In addition to the training required under paragraph .36, at least annually, the firm should provide mandatory training, including training on *applicable professional and legal requirements*, to *firm personnel* to develop and maintain their competence and enable them to fulfill their assigned QC and *engagement* roles in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures.

QC 20 provides that policies and procedures are required to be established to provide the firm with reasonable assurance that personnel participate in CPE and other professional development activities that enable them to fulfill responsibilities assigned and satisfy applicable

CPE requirements.<sup>226</sup> In addition, SECPS member requirements provide that member firms are required to ensure that (1) all professionals in the firm residing in the United States, including CPAs and non-CPAs, participate in at least 20 hours of qualifying CPE every year and at least 120 hours every three years and (2) professionals who devote at least 25 percent of their time to performing audit, review or other attest engagements, or who have the partner- or manager-level responsibility for the overall supervision or review of any such engagements, must obtain at least 40 percent (eight hours in any one year and 48 hours every three years) of their required CPE in subjects relating to accounting and auditing.<sup>227</sup>

Through our oversight activities, we have observed situations where a lack of understanding of professional standards appears to have contributed to audit deficiencies. These problems have been observed in domestic firms and international firms, including firms that were not SECPS members.

In the concept release, we discussed that we were considering incremental training requirements to provide firms additional direction. Specifically, the concept release sought input from commenters on whether a new QC standard should address training subjects to be covered, firm personnel required to be trained, and whether there should be minimum requirements for the extent of training.

Generally, commenters supported retaining some requirements regarding technical training in the proposed standard. Commenters generally supported allowing firms to evaluate their training needs as part of the firm's risk assessment process, rather than including prescriptive requirements. One professional association supported a minimum training requirement. Two commenters suggested that the proposed standard provide an exemption from training requirements for persons who work a de minimis number of hours in a supporting role and with appropriate supervision.

Firms and related groups who addressed the issue did not support prescriptive requirements related to industry training. Other commenters suggested requirements for training in areas such as audit requirements, new accounting standards and SEC requirements, professional skepticism, emerging tools, technology, and ethics and independence.

We believe it is important for firms to provide training focused on areas where firm personnel need to develop or maintain their competence so that they may fulfill their QC and engagement roles. Under the specified quality response we are proposing, the firm would be required to provide training, including training on applicable professional and legal

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<sup>226</sup> See QC 20.13; QC 40.02, .05.

<sup>227</sup> See SECPS §§ 1000.08(d), 8000. The SECPS member requirements provide that "accounting and auditing subjects" should be broadly interpreted, and include, for example, subjects relating to the business or economic environments of the entities to which the professional is assigned.

requirements, that is mandatory for all firm personnel on an annual basis. This specified quality response would provide firms the ability to determine the type and extent of training necessary based on its personnel and the nature and circumstances of the firm and its engagements. For example, a firm may determine that training is necessary on a wide array of topics for a certain level of staff within the firm. Another firm may determine that training is necessary for one or more staff in a certain area due to a new client engagement or as a result of an area of development identified as part of a performance evaluation. A firm may also decide that it is necessary to provide repeat training as a periodic reminder of existing requirements, such as the auditor's responsibilities under Section 10A of the Exchange Act to address fraud, illegal acts, and going concern. Ultimately, the type and extent of training should be directed at whatever is necessary to enable firm personnel to fulfill their assigned QC and engagement roles in accordance with applicable professional and legal requirements and the firm's policies and procedures.

.49 The firm's periodic performance evaluations of the individual(s) assigned (1) ultimate responsibility and accountability for the QC system as a whole and (2) operational responsibility and accountability for the QC system as a whole should take into account the outcome of the evaluation of the QC system.

This proposed specified quality response relates to the quality objective in paragraph .44g., which provides that firm personnel are evaluated at least annually, incentivized to fulfill their assigned responsibilities and adhere to appropriate standards of conduct, and held accountable for their actions and failures to act.

Specific to the individuals assigned ultimate responsibility and accountability for the QC system as a whole and operational responsibility and accountability for the QC system as a whole, the firm's periodic performance evaluations of these individuals are required to take into account the results of the firm's evaluation of its QC system.<sup>228</sup> A firm would be able to determine its approach to comply with this specified quality response. For example, the firm may set targets and measure the outcome of the evaluation of the QC system against those targets. As another example, the firm may consider the individual's actions taken in response to identified QC deficiencies or major QC deficiencies, including the timeliness and effectiveness of such actions. The periodic performance evaluation of these individuals may be informal in a less complex firm or undertaken by a special committee in a more complex firm.

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<sup>228</sup> Evaluation of a firm's QC system is addressed in paragraphs .77-.78 of proposed QC 1000 and discussed in Section IV.L below.

.50 The firm should design, implement, and maintain policies and procedures regarding licensure such that the firm and *firm personnel* hold licenses or other qualifications required by the relevant jurisdiction(s) under *applicable professional and legal requirements*.

Laws or regulations may establish requirements for the professional licensing or other qualifications of the firm and firm personnel. Under this proposed specified quality response, the firm would be required to have policies and procedures regarding licensure such that the firm and firm personnel hold the required licenses or qualifications. The policies and procedures would address such matters as (1) the jurisdiction(s) where firm and firm personnel are required to hold licenses or other qualifications and (2) whether the firm and such firm personnel comply with the jurisdictions' requirements.

.51 The firm should design, implement, and maintain policies and procedures so that technological resources have the capacity, integrity, resiliency, availability, reliability, and security necessary to enable the operation of the firm's QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements*.

The proposed quality objective in paragraph .44h. provides that technological resources are to be obtained or developed, implemented, maintained, and used to enable the firm's QC system and the performance of its engagements. As part of the firm's quality response to this quality objective, the firm's technological resources should also have the characteristics described in paragraph .51. These characteristics enable the ongoing operation of the firm's QC system and performance of its engagements.

## 2. Current PCAOB standards

Proposed QC 1000 largely covers the same areas addressed in QC 20 and QC 40 for personnel management and assignment of responsibilities.<sup>229</sup> Existing PCAOB QC standards do not provide specific direction on the use of intellectual resources or technological resources, except for one application regarding independence.<sup>230</sup>

## 3. Key differences from other QC standards

Proposed QC 1000 includes an additional quality objective related to firm personnel complying with firm policies and procedures, which retains the concept in QC 20.03. Proposed

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<sup>229</sup> See QC 20.13 and .22.

<sup>230</sup> See SECPS § 1000.46 (requirement 4).

QC 1000 also includes an additional specified quality response related to the characteristics of a firm's technological resources.

## Questions

36. Are the proposed quality objectives for resources appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?
37. Does the proposed quality objective and specified quality response related to technological resources provide sufficient direction to enable the appropriate use of emerging technologies? If not, what additional direction is necessary?
38. Are the proposed specified quality responses for resources appropriate? If not, what changes to the specified quality responses are necessary for this component?
39. Should the proposed standard include a specified quality response that would require the use of technological resources by the firm to respond to the risks related to the use of certain technology by the firm's clients? If yes, what should the requirement be?

## J. Information and Communication

This component addresses the firm's processes for obtaining, generating, sharing, and using information to enable the design, implementation, and operation of the QC system and the performance of the firm's engagements, and for communicating information within the firm and to external parties.<sup>231</sup> Commenters, including firms and related groups, generally supported the approach described in the concept release for this component. Some of these commenters believed that requirements regarding information and communication would provide significant enhancements to existing PCAOB QC standards.

The information and communication area of the firm's operations serves the critical function of generating, gathering, and disseminating the information needed for the firm, including the QC system, to function. The process of determining information needs is iterative and ongoing; as the nature and circumstances of the firm change, information needs also change. The information and communication component of the QC system operates over this area of the firm's operations.

### 1. Proposed QC 1000

.52 This component addresses the firm's processes for obtaining, generating, and using information to enable the design, implementation, and operation of the QC system and the

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<sup>231</sup> Other aspects of the proposed standard also include specific provisions regarding communication (see, e.g., .16-.17 in Roles & Responsibilities, and .31 and .35 in Ethics & Independence).

performance of its *engagements*, and for communicating information within the firm and to external parties on a timely basis.

**a. Information and communication quality objectives**

The proposed standard would require the firm to establish a number of quality objectives for the information and communication component. These objectives are discussed in more detail below.

**i. Identifying, capturing, processing, and maintaining information**

.53 The *quality objectives* established by the firm with respect to information and communication should include the following:

- a. Information, whether from internal or external sources, is identified, captured, processed, and maintained by the firm's information system(s) to support the operation of the firm's QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements*.

Identifying, capturing, processing, and maintaining information is an ongoing process necessary to support the firm's QC activities and the performance of its engagements in accordance with applicable professional and legal requirements. Information systems vary from firm to firm and encompass various sets of activities involving people, processes, data, or technology, or some combination thereof. Some firms' information systems may be heavily reliant on IT aspects while other information systems may require more manual intervention. Firms would be able to determine the type of information systems necessary to achieve their quality objectives.

**ii. Exchange of information**

- b. The nature, timing, and extent of information communicated to *firm personnel* enables them to understand and carry out their responsibilities relating to activities within the firm's QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements* and the firm's policies and procedures.
- c. *Firm personnel* communicate information to the firm and other *firm personnel* to support the operation of the QC system and the performance of the firm's *engagements* in accordance with *applicable professional and legal requirements*.

Information is essential to firm personnel being able to understand and fulfill their responsibilities relating to the QC system and the performance of the firm's engagements. For example, through our oversight activities, we observed improved audit quality when there was regular, consistent communication among members of the engagement team.<sup>232</sup> The proposed quality objective is intended to prompt firms to tailor the nature, timing, and extent of information communicated based on firm personnel's responsibilities, including those related to the firm's policies and procedures.

Communication is generally an ongoing process that involves all firm personnel. For example, the firm communicates information to engagement teams, such as information obtained during the firm's acceptance and continuance process that is relevant in performing the engagement. Engagement teams also communicate information to the firm—for example, information about the client obtained during engagement performance that may assist the firm when evaluating whether to continue the client relationship. Two-way communication may also occur among firm personnel. For example, firm personnel performing engagements may exchange information directly with firm personnel performing activities within the firm's QC system, such as information to facilitate compliance with the firm's independence policies and procedures. The proposed standard emphasizes the need for two-way communication within the firm and the responsibility of all firm personnel to communicate information.

### iii. External parties

- d. Information is communicated to external parties in accordance with *applicable professional and legal requirements*.

Note: External parties may include, for example, company management, audit committees, and boards of directors; the SEC; the PCAOB; and other regulators.

- e. If a firm communicates firm-level or *engagement*-level information, such as firm or *engagement* performance metrics, to external parties, such information is accurate and not misleading and, with respect to any performance metrics, explains in reasonable detail how the metrics were determined and, if applicable, how the metrics or the method of determining them changed since performance metrics were last communicated.

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<sup>232</sup> See, e.g., 2019 Inspection Observations Preview at 5.

There are many circumstances in which firms communicate information about themselves and their performance to external parties. Some external communications are required by law or regulation, such as the transparency reporting that is required in some jurisdictions, and others are made by firms voluntarily, for example, in connection with marketing or recruitment efforts.

The concept release anticipated that a future PCAOB QC standard would expressly address required communications by the firm or engagement teams to audit committees, the SEC, the PCAOB, or otherwise as required by law, regulation, and PCAOB standards and rules.<sup>233</sup> The proposed standard would require the firm to establish a quality objective that addresses communications to external parties in accordance with applicable professional and legal requirements. This quality objective focuses firms on providing the necessary communications to external parties when required. Among other things, this objective (.53d.) would cover the completeness, accuracy, and timeliness of a firm's existing annual and periodic reporting to the PCAOB (i.e., Forms 2 and 3), Form AP, and, if adopted, Form QC.

We have also observed that some firms make external communications about firm-level or engagement-level information, such as firm performance metrics and financial data. For example, some firms publish transparency or audit quality reports, either voluntarily or in response to the requirements of other jurisdictions, that contain data such as:

- Revenue breakdown by service line, by year, or by geographic segment;
- Professional staff ratios;
- Staff turnover ratios;
- Average training hours per professional; and
- Partner workload.

In addition to transparency or audit quality reports, firms may communicate these data via webpages or other media, such as promotional publications, social media, interviews, or presentations via webcast or video.

Regardless of the form of communication and the type of information presented, we believe that firms' QC systems should address the integrity of firms' external communications about themselves. Such information can influence the views of relevant stakeholders, including audit committees determining whether to engage or retain an auditor and investors

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<sup>233</sup> This would include, for example, communications required under Section 10A of the Exchange Act, AS 1301, Form AP, or Form 2, or in conjunction with company listing requirements. *See, e.g., NYSE Listed Company Manual*, Section 303A.07(b)(iii)(A).

determining whether to ratify such an appointment. The proposed standard would require the firm to establish a specific quality objective that firm-level or engagement-level information communicated externally is accurate and not misleading and, with respect to any performance metrics, explains in reasonable detail how the metrics were determined and, if applicable, how the metrics or the method of determining them changed since performance metrics were last communicated. Our preliminary view is that a specific quality objective in this area would prompt firms to implement targeted policies and procedures that would address, for example, the quality and consistency of data and the need for context or explanation. This in turn would improve the informativeness, reliability, and comparability of such communications and avoid misleading the intended audience.

#### iv. Networks

- f. If the firm belongs to a network, information is communicated to or obtained from the network to enable the operation of the firm's QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements*.

If the firm belongs to a network, exchange of information between the firm and the network may play an important role in supporting the operation of the firm's QC system and the performance of its engagements. For example, if the network performs certain monitoring activities relating to the firm's QC system, the network's communication of information (e.g., results of its monitoring activities or any changes to its activities from the prior year) may result in the firm adjusting the nature, timing, and extent of its own monitoring activities. On the other hand, the firm may need to communicate to the network when there are changes to the firm's QC system that may affect the network's monitoring activities. Such exchange of information between the firm and the network enables both entities to carry out their responsibilities in accordance with applicable professional and legal requirements and the firm's policies and procedures.

#### v. Other participants

- g. If *other participants* are used in the firm's *engagements*:
- (1) The nature, timing, and extent of information communicated to *other participants* enables them to understand and carry out their responsibilities relating to activities within the firm's QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements* and the firm's policies and procedures; and

(2) Information is obtained from the *other participants*, such that those *engagements* can be performed in accordance with *applicable professional and legal requirements*.

Note: With respect to *other participants* that are firms, information to be obtained should include the conclusion of the most recent evaluation of the QC system of the *other participant* firm and a brief overview of remedial actions taken and to be taken.

h. If the firm participates in another firm's *engagement*, information is communicated to and obtained from the other firm such that the firm's work on the *engagement* is performed in accordance with *applicable professional and legal requirements*.

Note: This communication includes any instances of noncompliance with *applicable professional and legal requirements* that the firm identifies related to the other firm's engagements during the firm's monitoring and remediation procedures.

As discussed in the concept release, over the years, many firms have increasingly involved parties outside the firm in performing audit procedures and evaluating audit evidence. Working with other participants can differ from working with individuals within the firm. For example, auditor-engaged specialists<sup>234</sup> may have different professional training and experience and may operate under a different type of QC system, or none at all. Firms may experience differences in local norms and expectations when working with firms based in other jurisdictions. These and other factors give rise to risks in the communication between firm personnel and other participants, including the potential for misunderstandings regarding the audit effort needed to meet the objective of the other participant's work.<sup>235</sup> It is therefore imperative that appropriate communications take place between the firm and other participants to enable the other participants to understand and carry out their responsibilities relating to activities within the firm's QC system and the performance of its engagements in

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<sup>234</sup> AS 1210, *Using the Work of an Auditor-Engaged Specialist*, establishes requirements regarding the use of a specialist engaged by the auditor's firm ("auditor-engaged specialist") to assist the auditor in obtaining or evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure.

<sup>235</sup> See, e.g., *Planning and Supervision of Audits Involving Other Auditors and Dividing Responsibility for the Audit with Another Accounting Firm*, PCAOB Release No. 2022-002 (June 21, 2022).

accordance with applicable professional and legal requirements and the firm's policies and procedures.

For other participants that are firms, information obtained from the other participants would include the conclusion of the most recent evaluation of its QC system and a brief overview of remedial actions taken and to be taken. The proposed standard includes a footnote clarifying the most recent evaluation of the other participant firm's QC system refers to that firm's evaluation under paragraph .77 of QC 1000 as of the most recent November 30, if such an evaluation was performed, and otherwise to the most recent QC evaluation performed by the other participant firm under any professional standard.<sup>236</sup> This information may assist a firm in determining the nature and extent of supervision of the work of other participants or deciding whether other participants are fit to participate in the firm's engagements.

The firm may also participate in another firm's engagement as an other participant. For the same reasons that apply when the firm is issuing the engagement report and using the work of other participants, it is important that there is an appropriate exchange of information in order to enable the firm serving as an other participant to fulfill its role in accordance with applicable professional and legal requirements.

#### **b. Information and communication specified quality responses**

.54 In designing and implementing *quality responses* to address the *quality risks* in the information and communication component, the firm should include the specified *quality responses* in paragraphs .55 -.57. These specified *quality responses* alone will not be sufficient to enable the firm to achieve all established *quality objectives* for this component. Depending on the *quality risk* being addressed, specified *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

The proposed standard includes specified quality responses for the information and communication component of the firm's QC system. These specified quality responses either carry forward an existing requirement from our QC standards or are built on analogous provisions of other QC standards.

.55 The firm should communicate in writing its policies and procedures related to the operation of the firm's QC system and the performance of its *engagements to firm personnel* and *other participants* in a manner that is reasonably designed and implemented to enable *firm personnel* and *other participants* to understand and carry out their responsibilities relating to activities within the firm's QC system and the performance of its *engagements* in

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<sup>236</sup> See, e.g., ISQM1 paragraphs .53-.54; and SQMS No.1 paragraphs .54-.55.

accordance with *applicable professional and legal requirements* and the firm's policies and procedures.

The proposed requirement is intended to carry forward an existing requirement from our QC standards and extend it to cover other participants, not just firm personnel.<sup>237</sup> We believe that other participants may play an important role in the operation of the firm's QC system and the performance of its engagements and therefore it is imperative for these individuals to be aware of the firm's policies and procedures at the level required to enable them to carry out their responsibilities. For example, a firm would communicate to an EQR contracted by the firm its policies and procedures related to EQR review and independence. In addition, although the wording of the proposed requirement is different, the substance of the existing requirement is unchanged. Reference to "reasonably designed and implemented" is intended to capture the existing requirement to communicate in "a manner that provides reasonable assurance that those policies and procedures are understood and complied with" without repeating the reasonable assurance already captured by the overarching objective of the proposed QC standard.

Under our existing standard, the firm is also required to make timely communications to appropriate personnel regarding changes to its established quality control policies and procedures. We do not think it is necessary to address changes to policies and procedures separately; the requirement is to communicate policies and procedures as in effect, which includes changes to such policies and procedures over time. If the firm needs to communicate changes to its policies and procedures to enable firm personnel and other participants to understand and carry out their responsibilities, then the proposed specified quality response would require such communication.

.56 The firm should communicate information related to the monitoring and remediation process to *firm personnel* to enable them to take timely action in accordance with their responsibilities, including, to the extent necessary, a description of:

- a. Monitoring activities performed and the results of such activities, including, if applicable, monitoring activities performed by the network;
- b. Identified *engagement deficiencies* and *QC deficiencies*, including the nature, severity, and pervasiveness of such deficiencies; and
- c. Actions to address the identified *engagement deficiencies* and *QC deficiencies*.

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<sup>237</sup> See QC 20.23.

.57 The firm should communicate the result of the annual evaluation of the firm's QC system to the firm's partners, shareholders, members, or other principals, and the firm's board of directors or equivalent.

Given the importance of information generated from the monitoring and remediation process, the proposed standard includes a specified quality response that would require the firm to communicate such information to firm personnel to enable them to take timely action. In determining specific information to be communicated to firm personnel, including the nature and extent of such communication, the firm may consider the type of information that is relevant to the recipients given their roles and responsibilities within the firm. For example, information communicated to engagement teams may be focused on a description of identified engagement deficiencies and related remedial actions that are likely to be relevant to such firm personnel and their engagements. Information communicated to all firm personnel may relate to deficiencies identified through QC system-level monitoring activities, such as compliance issues in connection with the firm's ethics and independence policies and procedures.

In addition, the firm would be required to communicate the results of the annual evaluation of its QC system to certain individuals in firm leadership positions. These individuals may use this information in various ways, for example, as a basis for further communications to firm personnel about the importance of quality or to address concerns about the QC system in a timely manner. The proposed requirement is intended to reinforce firm leadership's responsibility and accountability for the firm's QC system.

## 2. Current PCAOB standards

Existing PCAOB QC standards focus principally on communication of certain information, specifically:

- Firm QC policies and procedures;<sup>238</sup>
- Weaknesses identified in the QC system or the level of understanding or compliance therewith;<sup>239</sup>
- Internal inspection findings;<sup>240</sup>

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<sup>238</sup> See QC 20.23.

<sup>239</sup> See QC 30.03.

<sup>240</sup> See QC 30.06.

- Principles that influence the firm’s policies and procedures on matters related to the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided;<sup>241</sup>
- Additions to the Restricted Entity List; and <sup>242</sup>
- Notification to the SEC of resignations and dismissals from audit engagements for SEC registrants.<sup>243</sup>

The proposed standard, by contrast, would more broadly address the firm’s responsibilities regarding its information system and internal and external communications.

### 3. Key differences from other QC standards

Other QC standards refer to “relevant and reliable” information in describing the quality objectives for the information and communication component. We propose not to use a similar qualifier. Under our proposed quality objective, information would have to be such that it supports the operation of the firm’s QC system and the performance of the firm’s engagements in accordance with applicable professional and legal requirements. While that necessarily implies that information must be relevant and reliable, it is not limited to relevance and reliability. Rather, it speaks to every aspect (e.g., the quantity of the information, its timeliness, its accessibility) that affects whether the information supports the proper operation of the QC system and proper performance of engagements.

The proposed standard includes a specific quality objective that addresses communications to external parties about firm-level and engagement-level information, such as firm performance metrics. We believe that firm’s QC system should address the integrity of firms’ external communications about themselves. Other QC standards do not have a similar quality objective.

As discussed above, proposed QC 1000 includes an additional specified quality response that would require the firm to communicate in writing its policies and procedures related to the operation of the firm’s QC system and the performance of its engagements to firm personnel and other participants at the level required to enable them to perform appropriately. Other QC standards provide less detailed requirements.

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<sup>241</sup> See SECPS §§ 1000.08(l), 1000.42.

<sup>242</sup> See SECPS § 1000.46 (requirement 5).

<sup>243</sup> See SECPS § 1000.08(m); see also Appendix 5 for a proposed new standard, AS 1310, *Notification of Termination of the Auditor-Client Relationship*, that would retain existing requirements of SECPS § 1000.08(m) and apply those requirements to all firms.

Certain proposed communication requirements go beyond the requirements in other QC standards because of differences in the underlying proposed requirements for the monitoring and remediation process.

## Questions

40. Are the proposed quality objectives for information and communication appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?
41. Is the proposed quality objective addressing the firm's external communications about firm-level and engagement-level information appropriate? If not, what changes to the quality objective are necessary?
42. Are the proposed quality objective and specified quality response addressing information and communication related to other participants appropriate? If not, why not, and what changes are necessary?
43. Are there legal or regulatory concerns regarding other participant firms sharing the most recent evaluation of their QC system and a brief overview of remedial actions taken and to be taken? If so, please specify.
44. Are the proposed specified quality responses for information and communication appropriate? If not, what changes to the specified quality responses are necessary for this component?

## K. Monitoring and Remediation Process

### 1. Proposed QC 1000

#### a. Overview

.58 The monitoring and remediation process is an integral part of a QC system because it informs the firm's risk assessment process (i.e., the results of the monitoring and remediation process are taken into account when determining if changes to *quality objectives, quality risks, or quality responses* are necessary). The monitoring and remediation process applies to all of the components of the QC system, including monitoring and remediation, and provides the basis for evaluating and reporting on the QC system.

The monitoring and remediation process is an integral part of an effective QC system because it creates a feedback loop to inform the firm's risk assessment process. The feedback loop is intended to help the firm identify and assess new and evolving quality risks and design and implement effective quality responses. It is intended to drive a firm's focus on continuing to improve its QC system, with a view to preventing future engagement deficiencies. The

monitoring and remediation process applies to the design, implementation, and operation of all QC system components, including monitoring and remediation, and provides the basis for a firm's evaluation of whether its QC system is effective and for reporting on the QC system.<sup>244</sup>

We have observed through our oversight activities that some firms have made significant efforts to enhance their monitoring and remediation process, which has led to improvements in the firms' QC systems and in audit quality. These efforts include increased attention to ongoing monitoring activities, internal monitoring of both in-process and completed engagements, root cause analysis of both positive outcomes and QC deficiencies, and remedial actions to address QC deficiencies. However, our inspections continue to identify deficiencies for some firms, suggesting that not all firms have made meaningful improvements in these areas.

Under proposed QC 1000, the monitoring and remediation process addresses the following:

- General requirements;
- Engagement monitoring activities;
- QC system-level monitoring activities;
- Monitoring activities performed by a network;
- Determining whether engagement deficiencies exist;
- Responding to engagement deficiencies;
- Determining whether QC findings exist;
- Determining whether QC deficiencies exist;
- Responding to QC deficiencies; and
- Monitoring the implementation and operating effectiveness of remedial actions.

Under the proposed standard, a firm would perform monitoring activities to determine whether its quality responses are properly designed and operating as intended, such that the firm's quality risks are sufficiently mitigated and its quality objectives are achieved. As described later, the results of the firm's monitoring and remediation process would be evaluated annually as part of the evaluation of the QC system. Therefore, the monitoring

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<sup>244</sup> For further discussion of the evaluation of a firm's QC system, see Section IV.L below.

activities conducted need to be sufficient to support the conclusions reached during such an evaluation.

**b. General requirements**

- .59 The firm must design, implement, and operate a monitoring and remediation process to:
- a. Provide relevant, reliable, and timely information about the design, implementation, and operation of the QC system;
  - b. Provide a reasonable basis for detecting *engagement deficiencies* and *QC deficiencies*; and
  - c. Remediate identified *engagement deficiencies* and *QC deficiencies* on a timely basis.

The proposed standard specifies three objectives for the monitoring and remediation process:

- Relevant, reliable and timely information. Monitoring and remediation must provide information about the design, implementation, and operation of the firm’s QC system that is relevant, reliable, and timely. The information obtained from monitoring activities informs a firm about actions, behaviors, or conditions that contributed to issues that need to be addressed and may also provide insights as to factors that help prevent deficiencies from occurring. For example, information obtained about actions, behaviors, or conditions of an engagement subject to monitoring activities where the firm did not identify any deficiencies may provide insights about good practices to use when addressing issues on similar engagements.
- Reasonable basis for detecting engagement deficiencies and QC deficiencies. We propose to use the concept of “reasonable basis” as it is present throughout PCAOB auditing standards, including the standards governing the auditor’s report.<sup>245</sup> Therefore, this concept should be well understood by the profession.

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<sup>245</sup> See, e.g., AS 3101.09f (noting that one of the elements in the Basis for Opinion section of the auditor’s report is “[a] statement that the auditor believes that the audit provides a reasonable basis for the auditor’s opinion”).

- Timely remediation. The firm’s monitoring and remediation process must enable timely remediation of identified engagement deficiencies and QC deficiencies. What constitutes “timely” depends on the deficiency’s nature, scope, and impact. For example, where there is a high risk of severity or pervasiveness, remedial actions may have to be immediate to be timely.

- .60 The firm’s monitoring and remediation process includes:
- a. Designing and performing activities to monitor *engagements* and the design, implementation, and operation of the QC system (see paragraphs .62-.66);
  - b. Determining whether *engagement deficiencies* exist and responding to such deficiencies (see paragraphs .67-.70);
  - c. Determining whether *QC findings* and *QC deficiencies* exist (see paragraphs .71-.72);
  - d. Performing root cause analysis of *QC deficiencies* (see paragraphs .73-.74); and
  - e. Designing and implementing remedial actions to address *QC deficiencies* and determining whether such actions are implemented as designed and operate effectively (see paragraphs .75-.76).

The first element of monitoring and remediation is designing and performing monitoring activities for engagements and the QC system itself. Some commenters on the concept release suggested that a proactive risk-based approach would rely on a continuous improvement process supported by ongoing and periodic monitoring and remediation. We believe that the selected frequency and timing of the firm’s monitoring activities (e.g., a combination of ongoing and periodic monitoring activities) are important elements in achieving an overall effective monitoring and remediation process. Ongoing monitoring activities are generally those activities that are routine in nature, built into the firm’s processes, and performed on a real-time basis. Periodic monitoring activities, by contrast, are conducted at set intervals, and not on a real-time basis. The use of ongoing and periodic monitoring activities would vary by firm and be influenced by the nature and circumstances of the firm.

The other elements of the monitoring and remediation process specified in the proposed standard are:

- Determining whether engagement deficiencies exist and responding to them.
- Determining whether QC deficiencies exist.

- Performing root cause analysis of QC deficiencies.
- Designing and implementing remedial actions to respond to QC deficiencies and determining whether such actions are implemented as designed and operate effectively.

These other elements are discussed below, in relation to the proposed requirements of paragraphs .61-.76.

- .61 The firm’s monitoring activities must include:
- a. “*Engagement monitoring activities*,” which are directed at individual *engagements*; and
  - b. “*QC system-level monitoring activities*,” which are directed at the performance of activities under the requirements of this standard, including requirements relating to the components of the QC system.

The proposed standard differentiates engagement monitoring activities from QC system-level monitoring activities. Engagement monitoring activities are monitoring procedures performed on engagements performed under PCAOB standards,<sup>246</sup> including in-process and completed engagements. QC system-level monitoring activities are monitoring procedures regarding aspects of a firm’s QC system, including the firm’s risk assessment and monitoring and remediation processes.

We are proposing to specify that the QC system must include both engagement monitoring activities and QC system-level monitoring activities. The two types would provide different kinds of information and, in our view, a firm would need both in order to have a reasonable basis for detecting engagement and QC deficiencies and evaluating its QC system.

Notwithstanding the differences between engagement monitoring activities and QC system-level monitoring activities, a firm could design and perform dual-purpose monitoring activities – i.e., activities directed at individual engagements that also address aspects of the firm’s QC system. For example, a firm could perform engagement monitoring activities related to client acceptance and continuance on specific engagements that would also address the design, implementation, and operation of the client acceptance and continuance component of the firm’s QC system.

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<sup>246</sup> Monitoring activities with respect to audits performed under auditing standards of other standard setters would not constitute “engagement monitoring activities” under QC 1000.

The proposed standard defines “engagement” as any audit, attestation, review, or other engagement under PCAOB standards performed by a firm or in which a firm plays a substantial role in the preparation or furnishing of an engagement report. Under the proposal, substantial role engagements that the firm undertakes would be required to be included in the population of engagements on which the firm performs monitoring activities. In situations where the firm participates in another firm’s engagement but does not play a substantial role, sometimes called “referred work,” while such work would not be treated as the firm’s own “engagement” for purposes of the proposed standard, any firm that was required to implement and operate an effective QC system under the proposed standard would be required to extend its QC system to all audit, attestation, review, and other work it performs under PCAOB standards, including other firms’ engagements in which the firm plays less than a substantial role.

### c. Engagement monitoring activities

Engagement monitoring activities provide valuable information to firms on whether engagement or QC system-level areas may require additional attention. For example, monitoring procedures may highlight an area on an audit engagement where insufficient audit evidence was obtained to support the auditor’s opinion. More broadly, engagement monitoring activities may identify pervasive issues where a number of engagements have similar problems, possibly highlighting the need to revise methodology, provide additional training, or take other actions at the QC-system level.

#### i. Monitoring completed engagements

.62 The firm should:

- a. Monitor completed *engagements*; and
- b. As one element of its *engagement* monitoring, inspect on a cyclical basis at least one completed *engagement* for each engagement partner.

Note: A firm that uses a cycle longer than three years should demonstrate how that cycle is adequate to provide a reasonable basis for detecting *engagement deficiencies* and *QC deficiencies*, taking into account the factors in paragraph .64. Firms should consider incorporating a level of unpredictability in their selection of completed *engagements*, such that an engagement partner would not be certain which *engagement* would be selected or when an *engagement* would be selected.

The proposed standard would require firms to perform engagement monitoring activities on completed engagements. Part of this would involve selecting at least one completed engagement to inspect for each engagement partner on a cyclical basis.

The concept release sought comment on whether all firms should be required to conduct internal inspections of their completed engagements as part of their monitoring activities. Several firms and related groups expressed concern about having such a requirement. Some firms advocated that our proposed standard should provide firms the ability to determine the type of engagement monitoring activities to perform based upon the firm's unique characteristics, including their risk assessment. A few of these commenters cautioned that requiring the inspection of completed engagements could divert monitoring resources that otherwise could be used for performing other, more effective, monitoring activities. Some firms also cautioned that monitoring completed engagements could become less relevant if innovative monitoring procedures emerge in the future. One of these commenters suggested that prescriptive requirements could dissuade firms from developing proactive engagement monitoring techniques.<sup>247</sup> Some firms indicated that firms may find it more effective to monitor in-process engagements because of the benefits of providing real-time insights and preventing an inappropriate audit from occurring.

Other commenters, including firms, were supportive of a standard that would require inspections of completed engagements, acknowledging that they provide valuable feedback to the firm's monitoring and remediation process. One firm further explained that the data developed through internal inspections of completed engagements enables a firm to identify audit quality events, both positive and negative, that drive future enhancements and changes to the audit process. Another commenter highlighted that inspections of completed engagements also discourage firm personnel from "slacking off" since one of their engagements could be inspected without advance notice.

Our preliminary view is that the benefits obtained from performing inspections of completed engagements justify requiring all firms to include them as part of the monitoring process. The information derived from performing inspections of completed engagements provides the firm a perspective on its engagements that cannot be obtained through other monitoring activities. In addition, most firms perform engagement monitoring activities on their completed engagements as part of their existing QC practices. Requiring the inspection of completed engagements would therefore not change practice for most firms and, accordingly, seems unlikely to impose incremental costs in many instances.

Firms would be able to determine what activities to perform when monitoring completed engagements. This non-prescriptive approach should mitigate some of the concerns

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<sup>247</sup> Performance measures, engagement tracking tools, and reviews of in-process engagements are examples of proactive engagement monitoring techniques used by some firms.

expressed by commenters. The proposed standard also contemplates that firms may (and some firms would be required to) perform other types of engagement monitoring activities (see paragraph .63 below).

The proposed standard would require firms to establish a cyclical basis for monitoring completed engagements such that each engagement partner would have at least one engagement subject to monitoring in each cycle. A three-year period appears to be a norm for other standard setters and, based on our oversight activities, is common in practice.<sup>248</sup> We have included a note to the proposed standard that if a firm uses a cycle longer than three years, the firm would be required to demonstrate how its cycle is adequate to provide the firm with a reasonable basis for detecting engagement deficiencies and QC deficiencies, taking into account the factors in paragraph .64.

Regardless of the cyclical period used by the firm, risks or other circumstances related to an engagement or an engagement partner may trigger the need for the firm to inspect an engagement partner's completed engagement(s) more than once during the cyclical period.

The firm's selection of completed engagements should be responsive to information obtained from various sources, including prior monitoring activities. The proposed standard, in paragraph .64 (discussed further below), includes factors for a firm to take into account when selecting engagements for monitoring. These factors are intended to assist a firm when determining its cyclical basis and selecting at least one engagement to inspect for each engagement partner.

The proposed standard would require firms to consider incorporating a level of unpredictability when determining when, during the cyclical period, an engagement partner will have an engagement selected for monitoring and which completed engagement(s) to select. In our view, this would make it less likely that engagement partners would be in a position to manage engagements with the expectation that they would or would not be inspected.

Some commenters were in favor of a standard that required at least one engagement for each engagement partner to be inspected on a cyclical basis. One commenter suggested that the standard specify a cyclical basis of three years, whereas a firm suggested that firms determine the cyclical basis. Several other firms and a related group emphasized that the standard should allow firms to focus on their risks when determining how often to select

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<sup>248</sup> The application material accompanying the IAASB and AICPA QC standards provide an example of a three-year inspection cycle for engagement partners performing financial statement audits. See ISQM 1 paragraph A153, SQMS 1 Paragraph A165.

completed engagements to inspect. A couple of firms also indicated that specifying frequency could impede the scalability of the standard.

We are proposing to require firms to inspect at least one completed engagement for each engagement partner over a cyclical period so that firms would regularly evaluate the work of every partner to determine whether engagement deficiencies or QC deficiencies have occurred and could design and implement appropriate remedial actions.

#### ii. Monitoring in-process engagements and other work

- .63 In addition to monitoring completed *engagements*,
- a. If the firm issued audit reports with respect to more than 100 issuers during the prior calendar year, the firm should monitor in-process *engagements*;
  - b. If the firm issued audit reports with respect to 100 or fewer issuers during the prior calendar year, the firm should consider monitoring in-process *engagements*; and
  - c. If the firm participates at a level below a substantial role in another firm's *engagement*, the firm should consider performing monitoring activities on such work.

The proposed standard would require firms that issue audit reports with respect to more than 100 issuers during the prior calendar year to monitor in-process engagements, and it would require all other firms to consider monitoring in-process engagements. Therefore, all engagements would be included in the population of in-process engagements subject to monitoring, including audits of issuers, broker-dealers, and substantial role engagements. Monitoring in-process engagements can help firms detect and prevent potential engagement deficiencies before an engagement report is issued, resulting in a more proactive, preventive monitoring approach.

Through our oversight activities, we have observed a variety of different in-process engagement monitoring activities, including:

- Monitoring activities on a specific area of the audit after the engagement team has conducted certain audit procedures (e.g., an in-process reviewer evaluates an engagement team's testing of management's earnings forecast used in an impairment analysis);
- Engagement team coaching by an individual who is not part of the engagement team (e.g., a member of the firm's national office works with an engagement team

- to review their audit approach, including the nature, timing and extent of planned audit procedures);
- Evaluating an engagement team's progress against certain defined milestones or performance metrics and taking appropriate action when such milestones or metrics are not achieved (e.g., if an engagement partner did not review an engagement team's planning memo before interim audit procedures were to start, adjusting the engagement team's schedule so that the document could be reviewed and comments addressed before starting interim work; if an engagement team's hours exceed a certain weekly threshold, taking action by identifying and adding additional resources to the team); and
  - Monitoring engagement team turnover during the engagement and taking appropriate action when issues arise (e.g., if more experienced or senior personnel on the engagement, such as the manager or senior manager, leaves the firm during the engagement and prior to the completion of procedures, taking actions to ensure the engagement team has the necessary resources to complete the engagement).<sup>249</sup>

It would be up to each firm subject to the proposed requirement to determine the extent of its in-process engagement monitoring activities. A firm's approach should be grounded in the nature and circumstances of the firm and its engagements and the scope and nature of its other monitoring activities. For example, when determining for which engagements to perform in-process monitoring, a firm would leverage the factors presented in paragraph .64 of the proposed standard to identify engagements where there is a greater risk of noncompliance with applicable professional or legal requirements. Similarly, these factors would also assist a firm in determining the riskier areas of such engagements upon which to perform in-process engagement monitoring activities.

The concept release sought comment on whether a standard should include requirements for firms to adopt engagement monitoring activities that would prompt them to proactively prevent or detect engagement deficiencies, such as monitoring in-process engagements. A professional association and an investor advocate supported a standard that would require in-process engagement monitoring. Several commenters, including firms, highlighted the benefits of performing in-process engagement monitoring activities, including providing engagement teams with timely feedback that can be incorporated into their audit prior to the completion of fieldwork. However, some of these commenters, along with several others, expressed concern that overly prescriptive requirements would result in a loss of flexibility for firms to design and execute reviews that are responsive to their identified and assessed quality risks. Another commenter emphasized that monitoring in-process

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<sup>249</sup> In-process engagement monitoring activities under this standard have a different purpose than the responsibilities of the EQR under AS 1220.

engagements should be viewed as part of the engagement performance component rather than the monitoring and remediation process, expressing concern that considering such activities as monitoring would create challenges in determining if a potential QC finding or deficiency would have been rectified through the firm's other quality procedures, such as engagement quality reviews, unless these other quality procedures are able to function to completion.

We understand that monitoring in-process engagements may be challenging for some firms based on their size and nature. The proposed standard includes a "should consider" requirement to provide sufficient scalability for firms that issue audit reports with respect to 100 or fewer issuers. Under the proposed standard, firms that audit 100 or fewer issuers would be expected to reach a conclusion about whether to monitor in-process engagements in light of identified quality risks and quality responses.

We believe that differentiating a firm's obligation based on the number of issuer clients may be appropriate because, in our view, firms with larger, more complex audit practices may generally be subject to quality risks for which in-process monitoring would be an appropriate quality response. We propose to base the requirement on the size of a firm's issuer audit practice rather than its broker-dealer audit practice, as we believe the number of a firm's issuer clients is more indicative of the firm's size and the complexity of its practice. And, as noted in Section IV.E.1.b above, firms are familiar with the threshold of more than 100 issuer audit reports.

In addition, firms with over 100 issuer clients typically have the resources to implement such procedures, and based on our oversight activities, the majority of them already monitor in-process engagements to some extent.<sup>250</sup> Conversely, the majority of firms with 100 or fewer issuers do not perform in-process engagement monitoring activities. Requiring these firms to perform such monitoring activities would significantly change current practice and may not be justified by the circumstances of every firm. However, due to the benefits of this proactive engagement monitoring, we are proposing that firms that do not meet the proposed threshold should consider monitoring in-process engagements.

In situations where the firm participates in another firm's engagement but does not play a substantial role, sometimes called "referred work," paragraph .63c. provides that the firm should consider performing monitoring activities on such work. When deciding whether and when to do so, and what monitoring activities to perform, firms should take into account the factors identified in paragraph .64 (discussed further below), such as the firm's monitoring and external inspection history and the risks associated with the performance of the work. In addition, if a substantial portion of the firm's activities that are subject to the QC system relate

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<sup>250</sup> In 2021, ten of the twelve annually inspected firms performed some in-process engagement monitoring activities.

to referred work, the firm would make that decision in light of the overall objectives of the QC system.<sup>251</sup>

iii. Designing engagement monitoring activities, including selecting which engagements to monitor

.64 In determining the nature, timing, and extent of *engagement* monitoring activities, including which completed or in-process *engagements* to select for monitoring, the firm should take into account the following factors:

- a. *Quality risks* and the reasons they were assessed to be *quality risks*;
- b. The design of *quality responses*, including their intended timing, frequency, and scope;
- c. The nature, timing, extent, and results of previous monitoring activities undertaken by the firm and, if applicable, the network, including from inspections of completed *engagements*, inspections of in-process *engagements*, monitoring of work performed on other firms' *engagements*, and QC system-level monitoring activities;
- d. Information obtained from oversight activities by regulators, other external inspections or reviews, and, if applicable, monitoring activities performed by the network;

Note: The firm cannot rely solely on monitoring activities performed by others (e.g., network activities, regulatory inspections, or peer reviews) in lieu of performing its own inspections of completed *engagements*.

- e. Characteristics of particular *engagements*, such as the industry, the type of *engagement* (e.g., issuer audit, broker-dealer audit, attestation), the location(s) or jurisdiction(s) in which the client is located or the work is to be performed, whether it is a new *engagement* for the firm, and the experience and competence of the individuals assigned to the *engagement*;
- f. Characteristics of particular engagement partners, such as their experience, their competence, the results of internal and external inspections of their work, and the firm's cycle for inspecting their *engagements*; and
- g. Other information relevant to the risks of noncompliance with *applicable professional and legal requirements*, such as emerging developments, changes in

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<sup>251</sup> See paragraph .05a.(2) of the proposed standard.

economic conditions, new accounting or auditing standards, circumstances in which the firm has withdrawn its *engagement* report, restatements, complaints and allegations of which the firm is aware, and other events affecting one or more *engagements*.

The proposed standard includes factors for firms to take into account when determining the nature, timing, and extent of engagement monitoring activities, including which completed or in-process engagements to select for monitoring. These factors reflect aspects of a firm and its engagements that could create a greater risk of noncompliance with applicable professional and legal requirements. A firm would tailor its monitoring activities to address the particular circumstances of the firm and select engagements for monitoring based upon their specific risks. Developing performance metrics for the QC system, while not required, may be helpful in this process.

The proposed factors are:

- Quality risks and the reason for their assessments and the design of quality responses. For example, the complexity of or changes to applicable professional and legal requirements and the firm's policies and procedures may present a quality risk that the firm may not timely communicate the required use of a practice aid for planning audit procedures when certain fraud risk factors are present. In response to this risk, the firm could design its engagement monitoring activities to verify the engagement team's use of the practice aid. The earlier these monitoring activities can be performed, the more proactive the firm could be in planning audit procedures that would address audit issues as they arise.
- The nature, timing, extent, and results of previous monitoring activities. This includes insights learned from previous engagements and QC system-level monitoring activities that can be applied when determining engagement monitoring activities to perform. For example, in selecting engagements for monitoring, the firm would take into account deficiencies identified in previous engagements for the same client and other engagements where a similar deficiency could exist. As another example, engagement deficiencies related to inventory obsolescence testing identified by a firm through prior year engagement monitoring activities may prompt a firm to monitor the testing of inventory obsolescence on more engagements in the current year.
- Information obtained from oversight activities by regulators, other external inspections or reviews, and, if applicable, monitoring activities performed by the network. Information obtained from network monitoring activities or external reviews could provide a firm direction as to, for example, the type of procedures to

perform or when to perform them. The results of network monitoring activities or information obtained from external reviews could also identify issues that may exist on other similar engagements of the firm, prompting a decision to monitor some or all of these other engagements. For example, if an engagement was recently inspected through network monitoring activities or an external review, a firm may determine that selecting the same engagement for internal inspection would be unnecessary. Note, however, that a firm cannot rely solely on network monitoring activities or external inspections by regulators of individual engagements without performing its own engagement monitoring activities.

- Characteristics of a particular engagement. Factors such as the industry, the type of engagement (e.g., issuer audit, broker-dealer audit, attestation), the location(s) or jurisdiction(s) in which the client is located or the work is to be performed, whether it is a new engagement for the firm, and the experience and competence of the engagement team could affect conduct and outcomes of the engagement. For example, if the engagement team members are all new to the engagement, their lack of historical knowledge may present an additional risk for that engagement and provide a basis for its selection for monitoring.
- Characteristics of particular engagement partners. Factors such as the experience and competence of engagement partners, the results of internal and external inspections of their work, and the firm's cycle for inspecting their engagements could impact the risks of noncompliance with applicable professional and legal requirements associated with an engagement, whether positively or negatively. For example, an engagement partner's lack of experience in an industry the client recently entered may create additional risks to complying with applicable professional and legal requirements. Therefore, performing engagement monitoring activities on such engagement may be appropriate.
- Other information relevant to the risks of noncompliance with applicable professional and legal requirements. The standard includes a non-exhaustive list of examples.

The concept release sought input from commenters on whether a future standard should establish requirements for internal inspection selection criteria. The majority of commenters, including firms and related groups, opposed a standard that would require inspection of engagements that met certain selection criteria. Many of these commenters suggested that the criteria should be determined by each firm based upon its risks. Some commenters, including firms, also expressed concern that prescriptive selection criteria would create scalability issues for smaller firms. One commenter suggested that establishing engagement selection criteria would be beneficial. One firm suggested that, rather than establishing specific selection criteria, a standard could include factors for firms to consider

when selecting engagements to inspect, such as an engagement partner's review history, industry consideration, or engagement-specific facts and circumstances, that may indicate a heightened quality risk.

The proposed requirement is both principles-based and risk-centered, rather than prescriptive. It provides for scalability by including factors for firms to take into account when determining the nature, timing, and extent of engagement monitoring activities. In addition to the factors included in the proposed standard, a firm may identify other factors that are also relevant based on the nature and circumstances of the firm and its engagements.

#### d. QC system-level monitoring activities

.65 In determining the nature, timing, and extent of QC system-level monitoring activities, the firm should take into account the following factors:

- a. *Quality risks* and the reasons they were assessed to be *quality risks*;
- b. The design of *quality responses*, including their intended timing, frequency, and scope;
- c. For monitoring activities over the firm's risk assessment process and monitoring and remediation process, the design of those processes (including any performance metrics that the firm may have developed for its QC system);
- d. Changes or anticipated changes in the QC system;
- e. The services or resources provided by *other participants* or *third-party providers* in the firm's QC system, when applicable;
- f. The results of previous monitoring activities and remedial actions taken to address previously identified *QC deficiencies*;
- g. Information obtained from oversight activities by regulators, other external inspections or reviews, and, if applicable, monitoring activities performed by the network;

Note: The firm cannot rely solely on monitoring activities performed by others (e.g., network activities, regulatory inspections, or peer reviews) in lieu of performing QC system-level monitoring activities.

- h. Complaints and allegations of which the firm is aware; and

i. Other relevant information of which the firm is aware.

The proposed standard includes factors for a firm to take into account when determining the nature, timing, and extent of QC system-level monitoring activities.

Due to their nature, some of the factors are consistent with the factors a firm would be required to take into account when determining the nature, timing, and extent of engagement monitoring activities, such as the design of quality responses. The specific features of a firm's quality responses would be relevant for a firm to consider when designing QC system-level monitoring activities. For example, a firm's quality responses related to acceptance and continuance of client relationships and specific engagements might include a policy that firm personnel complete a checklist and assemble information evaluated by the engagement partner before making a recommendation to firm leadership on whether to continue with an engagement for the upcoming year. Based on this quality response, a firm might design QC system-level monitoring activities that include a review of the checklist and documentation for a selection of engagements.

Some other factors the proposed standard would require firms to take into account when determining the nature, timing, and extent of QC system-level monitoring activities include:

- The design of a firm's risk assessment and monitoring and remediation processes. The design of these processes would be relevant when designing monitoring activities to evaluate if such processes are implemented and operating effectively. For example, a firm may monitor the cyclical basis determined by the firm for inspecting engagement partners' completed engagements. A firm's monitoring activities in this area could include whether the firm is complying with the established period for selecting completed engagements as well as evaluating whether changes to the period may be necessary based on the results of other monitoring activities. The firm could also develop performance metrics for its QC system and use them in its monitoring and remediation process.
- Changes in the QC system. As a firm's QC system would be continuously evolving in response to changes in risks, the firm would have to determine whether previous monitoring activities were still relevant. For example, changes to a firm's quality response would be an indication that changes to the activities that monitor the design, implementation, and operation of such response may be necessary.
- When applicable, services provided by other participants in the firm's QC system. A firm may use other participants in its QC system (for example, other participants

may assist with engagement quality reviews). In these circumstances, the firm could monitor other participants' compliance with PCAOB standards.<sup>252</sup>

A firm's monitoring activities may vary over time as a firm takes into account the factors included in the proposed standard (see paragraphs .64–.65). Since a firm's QC system is a continuous and iterative process, such factors may lead a firm to perform different monitoring activities or employ different monitoring approaches over time.

**e. Monitoring activities performed by a network**

.66 In circumstances when the network performs monitoring activities relating to the firm's QC system or its *engagements*, the firm should:

- a. Request and, if provided, evaluate:
  - (1) Information about the activities performed;
  - (2) Results of such activities; and
  - (3) Planned remedial actions by the network;
- b. Determine its responsibilities in relation to the monitoring activities of the network, such as assisting with monitoring activities or responding to the results of the activities performed by the network, and perform such responsibilities; and
- c. Adjust its monitoring activities as necessary.

Note: Network monitoring activities may include, for example, monitoring the effectiveness of network resources or services that firms in the network are required to or may use in their QC system and monitoring of other aspects of the firm's QC system and its *engagements*.

Networks employ a variety of different approaches to monitoring firm QC systems. Some networks perform monitoring activities either directly on the firm's QC system, such as monitoring a firm's compliance with QC policies and procedures established by the network and adopted by the firm, or on tools or other resources developed or purchased by the network and used by the firm, such as an independence tracking system. Other networks perform no monitoring activities.

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<sup>252</sup> See generally, e.g., AS 1220.

The nature and extent of the network's monitoring activities would inform a firm's approach to monitoring. To illustrate, if a firm used a network independence tracking system to identify matters that may bear on the independence of firm personnel, and if the network monitored the design and operation of the tracking system and provided the firm with relevant information about those activities, the firm would be required to evaluate the monitoring activities performed by the network on the tracking system. In performing its evaluation, the firm would have to understand the scope of the network monitoring activities, such as whether the firm's personnel were selected for monitoring procedures, and if so, whether the population selected was sufficient to provide a reasonable basis for detecting engagement and QC deficiencies. To the extent provided, the firm would also be required to evaluate the results of the testing performed by the network, and if deficiencies were identified, the remedial actions, if any, taken or proposed to be taken by the network. The firm would also determine its responsibilities in assisting the network with any monitoring or remediation activities related to the tracking system.

Regardless of any QC monitoring activities that a network may perform on behalf of the firm, the firm is ultimately responsible for its QC system. Therefore, under the proposed standard, the firm would be responsible for evaluating any information it obtains from the network about any QC monitoring activities the network performs.

A firm would be required to adjust its monitoring activities as necessary, based on the scope of the network's monitoring activities and the information the firm receives (or does not receive) from the network about those activities. In some situations, a firm may not receive information requested from the network about the monitoring activities the network performed; if the firm does not receive information to evaluate network activities, it would not be in a position to take such activities into account in planning its own activities. To illustrate, a network may provide information to a firm regarding the results of member firms' internal engagement monitoring activities, which the firm uses to evaluate the competence of other network firm personnel and their ability to participate in the firm's engagements. If, due to a change in a particular network firm's local privacy laws, the network is unable to provide such information regarding that member firm, the firm would need to evaluate that member firm's competence and ability using a different approach.<sup>253</sup>

#### **f. Performance metrics in monitoring**

The concept release asked whether firms should be required to establish quantifiable performance metrics (referred to as performance measures in the concept release) to assess the achievement of quality objectives. Several commenters, including investor groups, expressed support for a standard that would require firms to use performance measures as

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<sup>253</sup> Irrespective of how the evaluation is performed, the engagement partner's responsibility for the engagement and its performance would not change. See AS 1201.03.

part of their monitoring activities. Many of these commenters referenced audit quality indicators as a specific type of performance measure.<sup>254</sup> One investor advocate highlighted that when something gets measured, it gets managed. Some commenters, including investor groups, suggested requiring firms to use certain metrics that they believed were the most indicative of audit quality, and some recommended measurements related to workload and experience of engagement team personnel.

Several other commenters, including firms, acknowledged the benefits of using performance measures as part of a firm's monitoring activities, but expressed concerns about implementing such a requirement, including difficulties in developing a standard set of quantifiable performance measures that would address the unique risks of each firm. A number of firms and a related group noted that performance measures differ across firms due to factors such as size and complexity of the firm, client base and industry specialization, and organization structure and management. Some commenters, including firms, noted that qualitative measures are often as important as quantitative ones. Several commenters, including firms and groups representing companies, suggested that we should provide firms flexibility in determining which performance measures to use, if any. A couple of these commenters noted that more research is necessary before a universal set of performance measures can be established. One firm expressed concern that specific performance measures could be challenging and very costly to implement due to variations in firm QC tracking, terminology, systems, and processes. Another firm highlighted that relevant metrics will continue to evolve with changes in businesses and technologies, further emphasizing the difficulty in establishing a common set of metrics to be applied by all firms.

The proposed standard does not require firms to use quantifiable performance metrics in their monitoring activities or suggest the use of any particular performance metrics. We believe that further analysis and consideration, outside the scope of our proposed QC standard, would be required before standard setting in that area would be appropriate. However, depending on their circumstances, firms may find that developing performance metrics to monitor engagements and the QC system would enhance their ability to identify deficiencies, measure whether quality objectives have been met, and evaluate the effectiveness of remediation activities.

**g. Determining whether engagement deficiencies exist**

.67 The firm must evaluate the following information and, on a timely basis, determine whether *engagement deficiencies* exist:

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<sup>254</sup> In 2015, the PCAOB issued a concept release describing and seeking comment on 28 potential indicators. See *Concept Release on Audit Quality Indicators*, PCAOB Release No. 2015-005 (July 1, 2015).

- a. Information from *engagement* monitoring activities;
- b. *QC deficiencies* identified by QC system-level monitoring activities, as provided in paragraph .72;
- c. Information from monitoring activities performed by the network, if applicable;
- d. Information from oversight activities by regulators and other external inspections or reviews; and
- e. Other relevant information of which the firm becomes aware.

Note: The firm may become aware of other relevant information through, for example: (1) documentation being assembled for retention; (2) procedures performed on the subsequent year's *engagement*; (3) post-balance sheet review activities in connection with a securities offering; (4) whistleblower complaints; and (5) restatements.

The proposed standard would require firms to determine whether engagement deficiencies exist. As defined by the proposed standard, an engagement deficiency is an instance of noncompliance with applicable professional or legal requirements by the firm, firm personnel, or other participants with respect to an engagement of the firm, or by the firm or firm personnel with respect to an engagement of another firm. Engagement deficiencies include:

- Instances of noncompliance in which a firm did not adequately support its opinion—because the firm did not perform sufficient procedures, obtain sufficient appropriate evidence, or reach appropriate conclusions with respect to relevant financial statement assertions;
- Instances in which the firm did not fulfill the objective of its role in the engagement, such as not performing attestation services in accordance with AT No. 2; and
- Other instances of noncompliance with applicable professional and legal requirements with respect to a firm's engagement, which may include, for example,

not satisfying applicable independence requirements,<sup>255</sup> not making required communications to the audit committee,<sup>256</sup> or not filing Form AP.<sup>257</sup>

The proposed standard would require a firm to evaluate a variety of types of information in making its determination about whether an engagement deficiency exists, including internally developed information from monitoring activities, information from external parties like regulators and peer reviewers, and other relevant information of which the firm becomes aware. Beyond the sources specified in the proposed standard, a firm would not be expected to seek out other sources of information that may indicate an engagement deficiency exists. However, if the firm became aware of such information, the firm would be expected to evaluate it. For purposes of the proposed standard, the firm is “aware” of information if any partner, shareholder, member, or other principal of the firm is aware of such information as it relates to a client of the firm.

The proposed standard does not specify how a firm would evaluate the information to determine whether an engagement deficiency exists. Rather, it provides firms the ability to develop an approach for such evaluation. A determination that an engagement deficiency exists due to the firm not complying with a PCAOB reporting requirement may be relatively simple to make. For example, evaluating whether the firm filed a Form AP in accordance with Rule 3211 would not require a significant amount of effort. However, evaluating information indicating the firm did not perform the necessary audit procedures for an issuer’s revenue transactions to determine whether an engagement deficiency exists could be more complex, and therefore require a more in-depth analysis.

A firm’s determination as to whether an engagement deficiency exists would pertain to in-process engagements, completed engagements, and work performed on other firms’ engagements.

If a firm obtained information about a potential deficiency in an in-process engagement, whether from monitoring activities or other sources, the firm would be expected to evaluate the information to determine whether an engagement deficiency exists before the engagement report is issued. In that regard, it should be noted that identifying a problem while an engagement is in process may enable the firm to rectify the problem before an engagement deficiency could arise. Many professional and legal requirements that apply to performing an engagement impose ongoing responsibilities that are not completed until the engagement itself is completed. In relation to such ongoing responsibilities, if a problem is identified in an in-

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<sup>255</sup> See generally, e.g., Regulation S-X Rule 2-01, 17 C.F.R. § 210.2-01; PCAOB rules under Section 3. Auditing and Related Professional Practice Standards, Part 5-Ethics and Independence.

<sup>256</sup> See generally AS 1301.

<sup>257</sup> See PCAOB Rule 3211, *Auditor Reporting of Certain Audit Participants*.

process engagement but resolved before the engagement is completed, no engagement deficiency would arise. For example, if an engagement team initially failed to obtain sufficient appropriate audit evidence in its testing of revenue because it failed to perform a necessary procedure, the engagement team could still perform the procedure at a later time during the engagement; as long as sufficient appropriate audit evidence was obtained prior to the issuance of the report, there would be no engagement deficiency. On the other hand, some applicable professional and legal requirements (such as preliminary engagement activities, including client acceptance procedures, and certain required communications to the audit committee) are required to be complied with prior to or at the beginning of the engagement. With respect to those requirements, an engagement deficiency would arise if the required time for performance had passed and the required activities were not performed appropriately, even if the engagement was still in process.

The proposed standard would require determinations to be made on a timely basis. For completed engagements, the timeliness of the determination would depend on the nature of the information subject to evaluation. For example, if the information suggested other engagements may present a similar issue, then we would expect that determination to be made sooner so that the risk of engagement deficiencies on other engagements—whether in-process or completed—is mitigated.

#### **h. Responding to engagement deficiencies**

.68 When an *engagement deficiency* exists, the firm should:

- a. For *engagement deficiencies* relating to in-process *engagements*, take action to address the deficiency in accordance with *applicable professional and legal requirements* (to the extent necessary, before the issuance of the related *engagement* report(s)), such that the *engagement* report is appropriate in the circumstances;
- b. For *engagement deficiencies* relating to completed *engagements*, take action to address the deficiency in accordance with *applicable professional and legal requirements*, unless it is probable that the *engagement* report(s) are not being relied upon;

Note: The firm must treat as relied upon any *engagement* report that is included in the most recent filing on an SEC form that requires inclusion of such an *engagement* report.

- c. For *engagement deficiencies* relating to work performed on other firms' *engagements*, communicate the *engagement deficiency* to the other firm and take such remedial action as the other firm determines is necessary; and

- d. Evaluate whether similar *engagement deficiencies* exist on:
- (1) Other in-process *engagements*, or would arise if remedial action is not taken;
  - (2) Other completed *engagements*, unless it is probable that the *engagement* report(s) are not being relied upon; and
  - (3) Work performed by the firm on other firms' *engagements*;
- and if so, take actions described in .68a.-c. above, as applicable.

When a firm determines an engagement deficiency exists, the proposed standard would require a firm to take action to address the deficiency. The action taken would depend on whether the engagement deficiency related to an in-process engagement, a completed engagement, or work performed by the firm on other firms' engagements. In some instances, a firm may find it beneficial to perform a root cause analysis to determine what action to take.

**i. Engagement deficiency related to an in-process engagement**

For an engagement deficiency related to an in-process engagement, the proposed standard would require a firm to take action to address the deficiency in accordance with applicable professional and legal requirements. The nature of the engagement deficiency would determine what a firm would need to do to address it and the timing of the required action. For engagement deficiencies that could affect the auditor's report, remedial action would be required before the engagement report is issued, such that the engagement report issued is appropriate in the circumstances. In other instances, action would still be required to address the deficiency, but the firm would have more flexibility regarding when such actions are performed; remedial action could be performed either before the report is issued or afterwards (if afterwards, the provisions of paragraph .68b would apply).

**ii. Engagement deficiency related to a completed engagement**

For an engagement deficiency related to a completed engagement, the proposed standard would generally require firms to take action to address the engagement deficiency in accordance with applicable professional and legal requirements (discussed in more detail below in connection with proposed paragraph .70). However, no action would be required if it was probable that the engagement report was not being relied upon.<sup>258</sup> As an example, an indicator

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<sup>258</sup> The use of "probable" in the note to paragraph .68 would be consistent with how the term is used in FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1, which provides that an event is "probable" when it is likely to occur.

that a report is not being relied upon would be that the financial statements covered by the engagement report are no longer presented as comparable financial information in SEC filings.

The proposed standard includes a note that clarifies that the firm must treat an engagement report as being relied upon if the engagement report is included in the most recent SEC filing on a form that requires its inclusion. In our view, inclusion of an engagement report in an SEC filing indicates that the report could be relied upon by any user of the relevant financial statements or other subject matter addressed by the report.

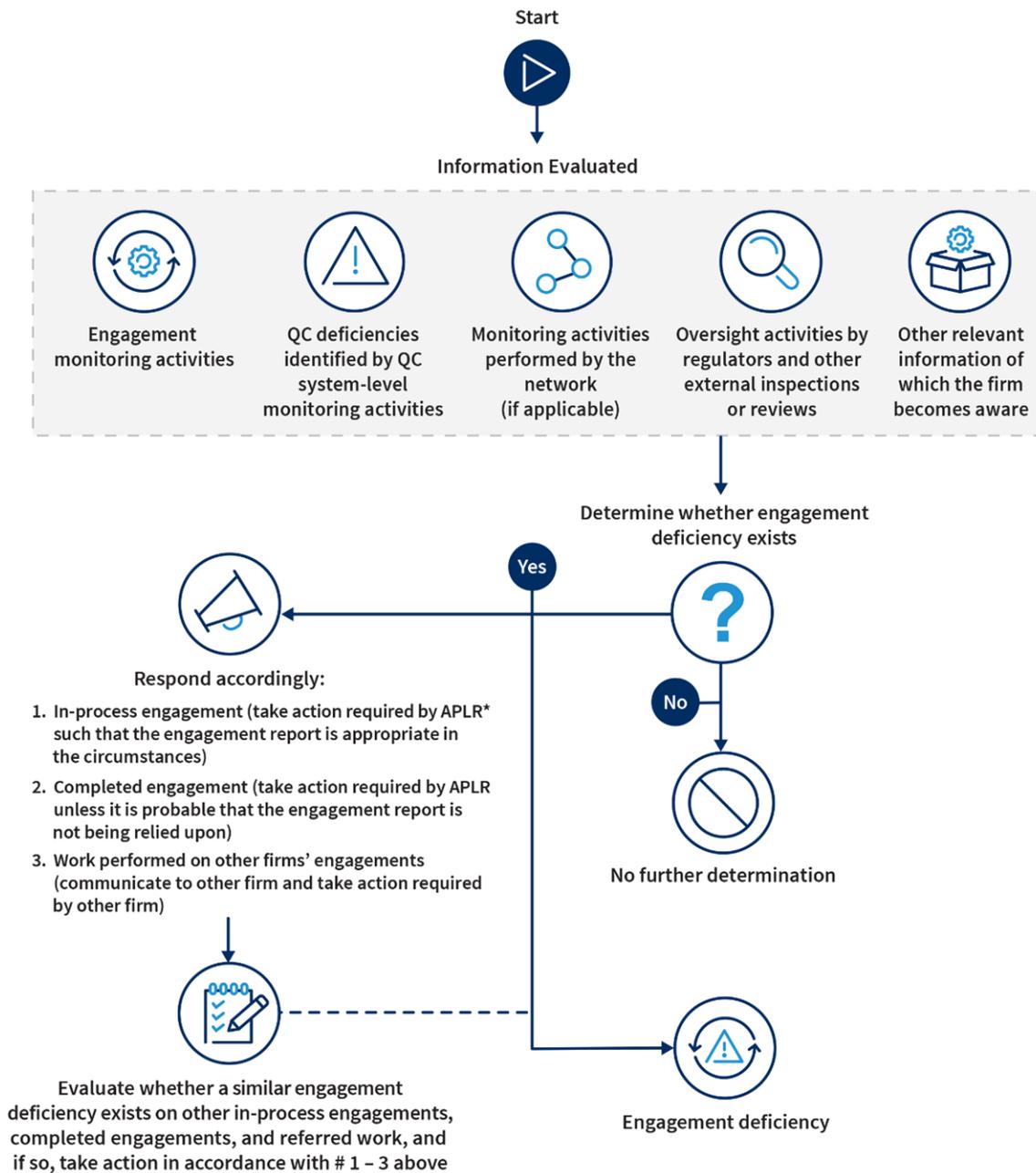
### iii. Engagement deficiency related to work performed on other firms' engagements

For an engagement deficiency related to work performed on other firms' engagements, the proposed standard would require a firm to communicate to the other firm the engagement deficiency. The communication should be sufficient to enable the other firm to develop a response commensurate with the extent of noncompliance. These engagement deficiencies, while there may or may not be additional remedial actions for the firm to take related to the particular work performed, would be included in the population of QC findings to be evaluated to determine whether QC deficiencies exist.

### iv. Evaluating whether similar engagement deficiencies exist

The proposed standard would also require a firm to evaluate whether similar engagement deficiencies exist in other in-process engagements, completed engagements (unless it is probable that the engagement report is not being relied upon), and work performed on other firms' engagements, and if so, to take actions as required by paragraphs .68a.-c. for in-process engagements, completed engagements, and any other referred-work activities. The nature of the engagement deficiency could assist the firm in determining the extent of the necessary evaluation. To illustrate, if the engagement deficiency was caused by an error in the firm's methodology for auditing a company's loan valuation allowance, then the firm could evaluate whether similar engagement deficiencies exist on engagements that were also using that methodology. As another example, if engagement team members did not comply with PCAOB standards when auditing accounts receivable because they failed to perform certain procedures in the firm's audit program, the firm could evaluate whether the person(s) who were responsible for performing the procedures and the person(s) supervising the work participated in any other audit engagement's accounts receivable testing, and if so, whether similar engagement deficiencies exist.

### Determining the Existence of and Responding to an Engagement Deficiency



\*APLR = Applicable professional and legal requirements

.69 The firm should take action pursuant to paragraph .68, taking into account the nature and severity of the *engagement deficiency*.

Note: Remedial actions a firm may take include: (1) corrective actions on in-process *engagements* to address *engagement deficiencies* before the issuance of the *engagement report*; (2) corrective actions to address *engagement deficiencies* on completed *engagements*; and (3) preventive actions to deter future *engagement deficiencies*.

The proposed standard would require firms to respond to engagement deficiencies by taking into account the nature and severity of the engagement deficiency. In other words, the response should be targeted based on the nature of the problem and proportionate to the severity of the problem.

Understanding the nature and severity of an engagement deficiency could assist firms in:

- Developing an appropriate response to the engagement deficiency;
- Determining whether an engagement deficiency could relate to other engagements; and
- Assessing whether the engagement deficiency, which represents a QC finding, is also a QC deficiency.

The remedial actions taken by the firm to respond to engagement deficiencies may include preventive or corrective actions (or a combination of these actions):

- *Corrective actions* are actions taken to rectify an identified deficiency in a current or completed engagement (for example, performing a procedure that had been omitted, designing and performing additional or alternative procedures if audit evidence is insufficient, or filing a required report).
- *Preventive actions* are actions taken to prevent the occurrence of a deficiency in future engagements (for example, training, developing audit tools, or enhancing audit methodology).

.70 For each *engagement deficiency* relating to a completed *engagement*, the firm should comply with paragraphs .98-.99 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* [as proposed to be

amended], AS 2901, *Responding to Engagement Deficiencies After Issuance of the Auditor's Report* [as proposed to be amended], AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, paragraphs 39.-42. of AT No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* [as proposed to be amended], and paragraphs 21.-24. of AT No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* [as proposed to be amended], as applicable.

The proposed standard would require firms to comply, as applicable, with other standards.

- AS 2901, as proposed to be amended,<sup>259</sup> would address auditor responsibilities with respect to engagement deficiencies on completed audit engagements. AS 2201.99, as proposed to be amended, would direct the auditor to comply with AS 2901.
- AS 2905 deals with auditor responsibilities when, subsequent to the date of a report on audited financial statements, the auditor becomes aware of facts that might have affected the report had he or she then been aware of such facts before issuing the report. AS 2201.98 is a similar provision relating to auditor's reports on internal control over financial reporting.
- AT No. 1 and AT No. 2, as proposed to be amended, incorporate responsibilities similar to those required under AS 2901, as proposed to be amended.

**i. Determining whether QC findings exist**

.71 The firm must evaluate the following information and, on a timely basis, determine whether *QC findings* exist:

- a. Information from *engagement* monitoring activities and QC system-level monitoring activities (including, if applicable, those performed by the network);
- b. Information from oversight activities by regulators and other external inspections or reviews; and
- c. Other relevant information of which the firm becomes aware.

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<sup>259</sup> Section V.A below discusses the proposed amendments to AS 2901, and the text of those proposed amendments appears in Appendix 3. The text of the proposed amendments to AS 2201, AT No. 1, and AT No. 2 appears in Appendix 5.

The proposed standard would require firms to determine whether QC findings exist. As defined by the proposed standard, a QC finding is a finding about the design, implementation, or operation of the firm's QC system that may indicate one or more QC deficiencies exists.<sup>260</sup> Under the proposed definition, any information that may indicate a problem with the design, implementation, or operation of the firm's QC system would be a QC finding.

Because a QC system provides reasonable assurance that engagements are conducted in accordance with applicable professional and legal requirements, all engagement deficiencies would be QC findings. Examples of other QC findings include an error in the design or operation of a technology tool or methodology, or information suggesting that a firm may not have achieved a quality objective.

The determination of QC findings involves collecting observations and related evidence that may indicate a QC deficiency exists, including information from monitoring activities, information from external parties like regulators and peer reviewers, and other relevant information of which the firm becomes aware.

Under the proposed standard, the results of all monitoring activities performed by the firm, and if applicable, those performed by the network, would be analyzed by the firm to determine if there are QC findings. It is possible that a firm's engagement monitoring activities could identify not only engagement deficiencies (which, by definition, are QC findings), but also other QC findings that are not engagement deficiencies. For example, if, as part of the firm's quality response related to technological resources, the firm's technology leader must review and approve all software audit tools used on engagements, and if a firm's engagement monitoring activities reveal that an engagement team did not receive the appropriate authorization to use a specific tool, that observation would be a QC finding, regardless of whether the use of the tool also gave rise to an engagement deficiency.

Oversight activities by regulators and external inspections or reviews include activities of the PCAOB and other regulators. As a firm would typically have one QC system for its entire audit practice, the results of the inspections, reviews, and other oversight activities performed by these external parties would likely be relevant to a firm's determination of whether QC findings exist.

Other relevant information of which the firm becomes aware would comprise information obtained from within and outside the firm. A firm would not be expected to seek out such other sources of information; however, if other relevant information came to the firm's attention, a firm would be expected to determine whether it is a QC finding. For example, the firm may become aware of an issue with a formula in a practice aid used to assist

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<sup>260</sup> QC deficiencies are defined and discussed in the next subsection. See Section IV.K.1.j below.

engagement teams in auditing stock-based compensation if a member of an engagement team communicates that issue to firm personnel supporting the firm's QC system.

**j. Determining whether QC deficiencies exist**

.72 The firm must evaluate *QC findings* to determine, on a timely basis, whether *QC deficiencies* exist. The firm's determination should be based on:

- a. The nature, severity, and pervasiveness of the matter(s) that gave rise to the *QC finding*, which includes:
  - (1) The component(s) of the QC system, *quality objective(s)*, or *quality risk(s)* to which the *QC finding* relates;
  - (2) Whether the *QC finding* is in the design, implementation, or operation of the QC system;
  - (3) The frequency with which the *QC finding* occurred; and
  - (4) The duration of time that the *QC finding* existed; and
- b. The likelihood that the matter(s) that gave rise to the *QC finding* could affect other components of the QC system, other *engagements* (including in-process *engagements* and completed *engagements*), *engagements* to be performed in the future, or work performed on other firms' *engagements*, and the severity of such an effect if it were to occur.

The proposed standard would require firms to determine whether QC deficiencies exist. The proposed standard defines a QC deficiency as a QC finding that, based on the evaluation under paragraph .72, individually or in combination with one or more other QC findings, results in:

- (1) A reduced likelihood of the firm achieving the reasonable assurance objective or one or more quality objectives; or

Note: The likelihood could be reduced if, for example, a quality objective is not established, a quality risk is not properly identified or assessed, or a quality response is not properly designed or implemented or is not operating effectively.

- (2) Noncompliance with requirements of this standard, other than those under "Documentation"; or

- (3) Noncompliance with requirements of this standard under “Documentation” that adversely affects the firm’s ability to comply with any of the other requirements of this standard.

The first subparagraph of the proposed definition of QC deficiency is similar to the definition of an internal control deficiency as defined by the COSO in its integrated framework.<sup>261</sup> Therefore, the proposed definition should be familiar to firms.<sup>262</sup> This subparagraph also includes a note to provide context as to when a QC finding could result in a reduced likelihood of the firm achieving the reasonable assurance objective or one or more quality objectives.

The proposed definition of QC deficiency includes noncompliance with the requirements of the proposed standard such as the requirements related to roles and responsibilities, the firm’s risk assessment process, the monitoring and remediation process, and the evaluation of the QC system. The proposed definition also includes noncompliance with the documentation requirements, to the extent that such noncompliance adversely affects the firm’s ability to comply with any of the other requirements of the proposed standard, while excluding other documentation issues. For example, a firm’s failure to document some details of its monitoring activities, in a context where the firm otherwise sufficiently documents the evaluation of the results from its monitoring activities, would not meet the proposed definition of a QC deficiency.

Under the proposed standard, the determination of whether something identified as a QC finding meets the definition of a QC deficiency would be based on the nature, severity, and pervasiveness of the underlying matter; the likelihood that it could affect other component(s) of the QC system or other engagements; and the severity of such an effect if it were to occur. In the case of engagement deficiencies, this evaluation would take account of the basis for the firm’s determination of the remedial actions required under paragraph .68 of this standard, including any root cause analysis performed.

- i. [Nature, severity, and pervasiveness of the matter that gave rise to the QC finding](#)

The nature, severity, and pervasiveness of the matter that gave rise to the QC finding would be taken into account when determining whether a QC deficiency exists. For a QC finding that is also an engagement deficiency, the results of the firm’s evaluation of whether a similar

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<sup>261</sup> See COSO Framework definitions (defining an internal control deficiency as “a shortcoming in a component or components and relevant principle(s) that reduces the likelihood of an entity achieving its objective”).

<sup>262</sup> See footnote 7 to AS 2201.05. Of the approximately 3,400 ICFR opinions filed in the 12 months ended July 31, 2022, only two did not cite COSO.

engagement deficiency exists on other in-process and completed engagements would provide useful information to the firm when determining whether a QC deficiency exists.

The proposed standard explains that the nature, severity, and pervasiveness of the matter that gave rise to the QC finding includes:

- The component(s) of the QC system, quality objective(s), or quality risk(s) to which the QC finding relates. Depending on the quality risks that a firm identifies, some components may play a greater role in its QC system than others. For example, for a small firm that audits one issuer and has no intention to expand its issuer audit practice, the engagement performance component would have a greater role than acceptance and continuance of client relationships and specific engagements because the quality risks associated with new client acceptance would be mitigated by the firm's policy of not taking on new issuer audit clients. Based on the firm's risk assessment, certain quality risks may pose a greater threat to the firm's QC system than others. In addition, some QC findings may relate to a single component of the QC system or a single quality objective, while others may relate to multiple components of the QC system or multiple quality objectives. For example, an engagement deficiency may relate to the resource component (e.g., competence and training of firm personnel, firm methodology), the information and communication component (e.g., failure to communicate changes to the methodology), or the engagement performance component (e.g., failure to consult when required), or all three of those components.
- Whether the QC finding is in the design, implementation, or operation of the QC system. For example, a matter that gave rise to a QC finding in the design of a process has a greater likelihood of being pervasive to a firm's practice than a process that did not operate as designed on one occasion.
- The frequency with which the QC finding occurred. Frequency relates to the number of times the matter that gave rise to the QC finding occurred—for example, on engagements within a particular industry sector or practice group, a particular office, or firmwide. It might also relate to the number of times the finding was identified, the number of firm personnel involved, or the number of quality objectives affected. When related to the execution of a firm's quality response, it would also include relative frequency of QC findings compared to the number of times the procedure was executed properly.
- The duration of time that the QC finding existed. Duration addresses how long the matter that gave rise to the QC finding existed. In order to understand duration, a firm would need to understand whether there were other instances previous to those initially identified by the firm as QC findings.

ii. Likelihood that the matter that gave rise to the QC finding could affect other component(s) of the QC system or other engagements, and the severity of such an effect

Whether a QC finding is a QC deficiency would also depend on the likelihood that the matter that gave rise to the QC finding could affect other QC system components or other engagements.

Other engagements would include in-process engagements, completed engagements, engagements to be performed in the future, as well as work performed on other firms' engagements. A firm may design and implement mitigating actions to address an engagement deficiency when such a deficiency comes to the firm's attention. When considering the likelihood that future engagements could be affected (for purposes of determining whether a QC deficiency exists), a firm would not take into account any mitigating actions, even if they have been implemented.

In addition to the likelihood of a matter's recurrence, the proposed standard would also require a firm to evaluate the matter's severity if it were to affect other component(s) or engagements.

iii. Example of QC deficiency determination

*The following example is illustrative of certain of the considerations relevant to determining QC deficiencies and is not intended to provide a complete description of the determination process.*

During a firm's monitoring and remediation process the firm may identify QC findings, which would have to be evaluated to determine whether they are QC deficiencies. For example, a firm may identify that revenue testing for an engagement was not completed in accordance with applicable professional and legal requirements because the auditor did not obtain sufficient appropriate audit evidence. Since this would be an engagement deficiency, it would by definition be a QC finding and would have to be evaluated to determine if it was a QC deficiency.

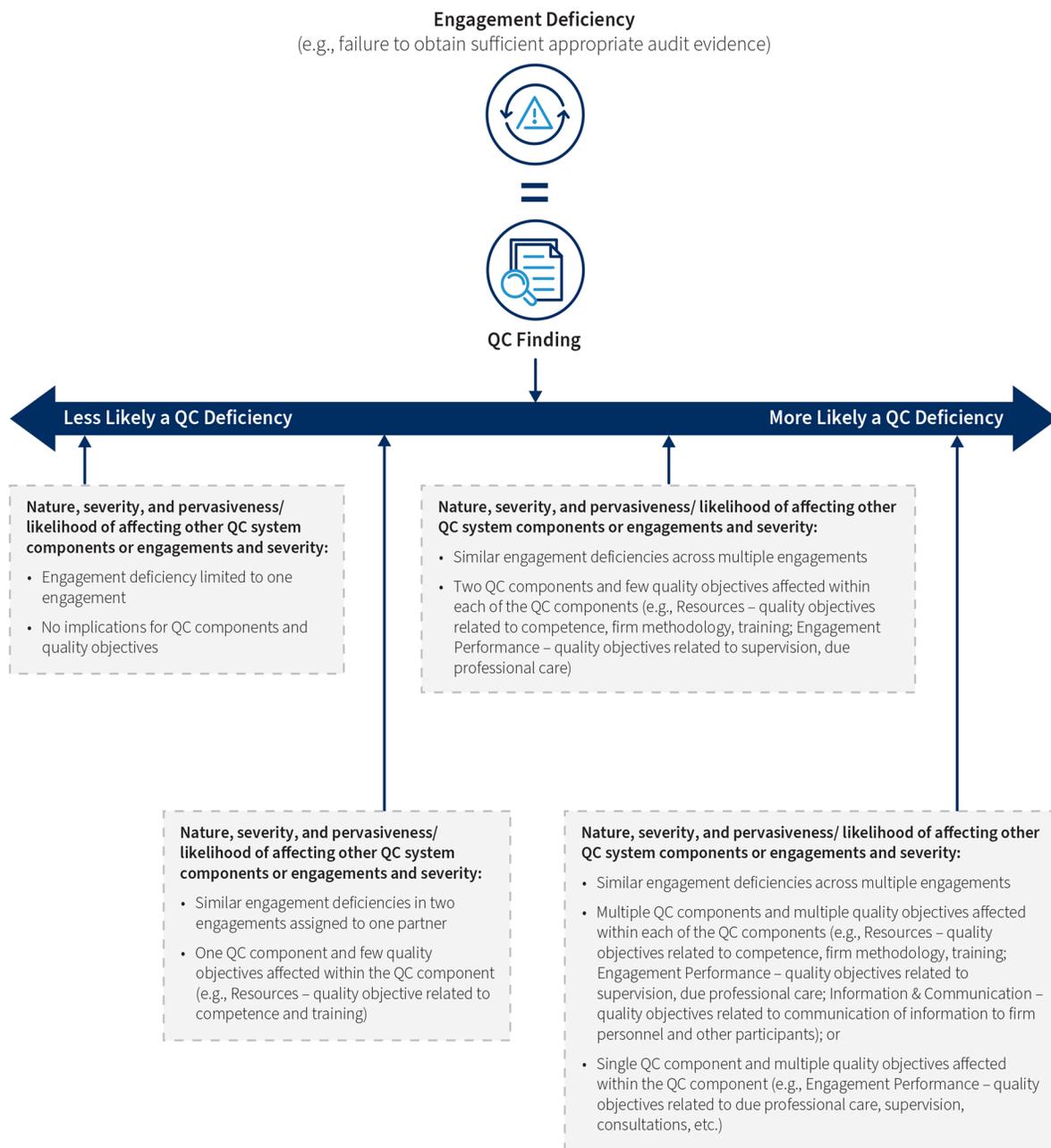
Specifically, the firm would have to determine whether the QC finding met the definition of QC deficiency. Depending on the nature of the QC finding, one or more quality objectives or requirements of this standard may be affected. In the revenue testing example, the QC finding most directly implicates engagement performance and resources and therefore may result in a reduced likelihood that the quality objectives for those components would be met. In principle, however, any of the firm's quality objectives and the reasonable assurance objective could be affected.

The firm would base its determination of whether a QC finding met the definition of QC deficiency on the factors in paragraph .72: the nature, severity, and pervasiveness of the matter that gave rise to the QC finding, and the likelihood that the matter that gave rise to the QC finding could affect other QC system components or other engagements and the severity of such an effect if it were to occur.

In the revenue testing example, the evaluation would depend on the underlying facts:

- *More likely a QC deficiency, based on the QC finding individually.* The QC finding on its own may evidence a QC deficiency. For example, if analysis of the QC finding reveals that an audit tool was not properly designed or that the firm's methodology was out of date, it would suggest a potentially severe and pervasive matter that likely could affect other engagements, and therefore is more likely to be a QC deficiency. In this example, at a minimum, certain quality objectives in the resources component could be affected. Depending on the nature and pervasiveness of the issue, other component quality objectives, as well as the reasonable assurance objective, may also be affected. Further, if the QC finding reveals multiple points of failure with respect to auditing revenue, it may constitute one or more QC deficiencies. This could occur if the matter that gave rise to the QC finding is severe and likely to implicate multiple components of the QC system (for example, a QC finding that evidences deficiencies in the resource component, such as training and competence; the engagement performance component, such as improper supervision and failure to exercise due professional care; and the information and communication component, such as a failure to properly communicate information to other participants to enable them to test a portion of a company's revenue).
- *More likely a QC deficiency, based on the QC finding in combination with one or more other QC findings.* It may be that the QC finding is part of a pattern of similar QC findings. If the audit tools and methodology for revenue testing seem appropriate but the engagement team misapplied them, the firm would consider whether a similar QC finding exists on other engagements. This could reveal a QC deficiency related, for example, to the training or competence of firm personnel.
- *Less likely a QC deficiency.* This may be the case for errors that do not appear to implicate any aspect of the QC system, such as an engagement team's failure to obtain sufficient appropriate audit evidence for revenue because the team entered incorrect information in the firm's sampling tool resulting in an insufficient sample.

### Example of Considerations Relevant to Determining QC Deficiency



## k. Responding to QC deficiencies

### i. Root cause analysis

.73 The firm should perform root cause analysis of all *QC deficiencies*. Root cause analysis involves identifying and evaluating the causal factors that led to each *QC deficiency*. The firm may perform root cause analysis of *QC deficiencies* individually or may group similar *QC deficiencies* together.

Root cause analysis is a widely used concept in QC frameworks. Identifying and understanding the underlying causes of a problem supports developing solutions that address those causes, rather than just the symptoms. Proper determination of the causal factors that led to QC deficiencies is essential to developing effective remedial actions. For example, a policy or procedure could be inappropriately designed or implemented or a person may not have complied with a policy or executed a procedure as it was intended. As another example, an audit tool may not have operated as intended. Root cause analysis looks for different types of causes through investigating the patterns of negative effects, finding hidden flaws in the QC system, and discovering specific actions that contributed to the problem. Improvements in audit quality have generally been observed through our oversight activities where a firm has established an effective root cause analysis program.<sup>263</sup> Many different types of causes may contribute to a problem.

A firm might find it helpful when performing root cause analysis to leverage information obtained from its evaluation of whether a QC deficiency exists. That is, information about the nature, severity, or pervasiveness of the matter that gave rise to the QC finding and the likelihood that the matter that gave rise to the QC finding could affect other components of the QC system or other engagements may provide evidence of what caused the problem to occur.

Root cause analysis procedures could take different forms depending on the circumstances, which allows for scalability. Some key elements that we have observed that we believe could lead to more robust and comprehensive root cause analysis include:<sup>264</sup>

- Process mapping at the engagement level and the firm level of the underlying work flows of how a firm conducts its practice. A well-defined process makes it easier to analyze negative events to determine what went wrong;

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<sup>263</sup> See George Botic, Director, PCAOB Division of Registration and Inspections, *Protecting Investors through Change*, AICPA Conference on SEC and PCAOB Developments (Dec. 12, 2018), available at [https://pcaobus.org/news-events/speeches/speech-detail/protecting-investors-through-change\\_693](https://pcaobus.org/news-events/speeches/speech-detail/protecting-investors-through-change_693).

<sup>264</sup> See June 2014 SAG Briefing Paper at 2.

- Consideration of both positive and negative quality events (i.e., actions, behaviors, or conditions that resulted in positive or negative outcomes) to identify whether such actions, behaviors, or conditions were present on engagements where QC deficiencies were identified; and
- Measuring, in real time, the effectiveness of remedial actions and audit quality improvement plans or initiatives to identify whether remedial efforts are effective.

.74 The nature, timing, and extent of the root cause analysis should be commensurate with the nature, severity, and pervasiveness of the *QC deficiency*.

The proposed standard requires that the nature, timing, and extent of the root cause analysis be commensurate with the nature, severity, and pervasiveness of the QC deficiency. For example, a QC deficiency that could affect multiple engagements may require more urgent root cause analysis, depending on the circumstances. To illustrate, a QC deficiency related to a firm's approach to testing business combinations would be more urgent if a firm's clients regularly enter into such transactions.

Taking into account the nature, severity, and pervasiveness of the QC deficiency, root cause analysis may be performed at different points in time or, depending on the size and nature of the firm, operate as more of a continual process. At times, it might be effective to combine similar QC deficiencies and perform root cause analysis on them collectively rather than on an individual basis.

In some instances, the causal factors may be relatively apparent and therefore require less analysis than a situation where the cause of the deficiency is complex and requires significant investigation and analysis. As previously mentioned, there may be multiple causes contributing to a QC deficiency. Generally, the more thorough the analysis, the more likely the causal factors will be identified and the greater the likelihood that a firm could design and implement remediation efforts that will be effective in preventing similar QC deficiencies from occurring again.

It is important for firms to have well-defined processes in order to perform sufficient root cause analysis. The better delineated the underlying processes, the less work that may be necessary to determine why the QC deficiency occurred.

The proposed standard does not require firms to perform root cause analysis on QC findings that are not QC deficiencies.

## ii. Remedial actions

.75 For each *QC deficiency*, the firm should design and implement timely remedial actions, taking into account the results of its root cause analysis and the nature, severity, and pervasiveness of the *QC deficiency*.

Note: When performing root cause analysis and identifying potential remedial actions for a *QC deficiency*, it may be beneficial for firms to consider actions, behaviors, or conditions that resulted in positive outcomes, such as where aspects of its QC system operate effectively or where no *engagement deficiencies* were identified for individual *engagements*. This information could provide useful insights when evaluating situations where *QC deficiencies* were identified and such actions, behaviors, or conditions were not present or were not present to the same degree.

The timing of a firm's efforts to design and implement remedial actions would be dependent on the results of the firm's root cause analysis and the nature, severity, and pervasiveness of the QC deficiency. We would expect a firm to respond in a manner that would mitigate the occurrence of additional QC deficiencies related to similar underlying causes.

In some circumstances, due to the extent of remedial actions necessary to address the QC deficiency, a firm might design and implement temporary remedial actions until permanent actions can be designed and implemented. For example, a firm could design and implement supplemental audit practice aids to address QC deficiencies until the firm is able to revise its comprehensive audit methodology. In some situations, a complex QC deficiency may result in the firm developing a multi-step plan with milestones necessary to be achieved as the firm designs and implements its remedial actions.

The process of identifying QC findings, determining QC deficiencies, performing root cause analysis, and designing and implementing remedial actions is iterative. For example, a firm may learn information from performing root cause analysis that may identify issues that would have been relevant when evaluating a different QC finding had such information been known at the time. If this were to occur, a firm would further evaluate the other QC finding to determine if a QC deficiency exists based on this new information. As another example, the work entailed in a root cause analysis could potentially help a firm identify other quality objectives that are not being met. To illustrate, the firm's root cause analysis may show that a lack of training caused deficiencies in a complex audit or accounting area that is common to the firm's engagements, and may also lead to the identification of other problems in the same area, such as inadequate audit methodology or a missed consultation due to the lack of a well-understood, robust consultation process.

Our oversight activities have identified that some firms evaluate positive quality events associated with engagements where no engagement deficiencies were identified. For example, certain procedures, techniques, or voluntary practice aids may have contributed to an engagement performed in accordance with applicable professional and legal requirements. These firms use the information obtained from such evaluations to assess the actions of individuals on engagements with deficiencies, ultimately highlighting potential actions to prevent future engagement deficiencies. We believe that evaluating positive outcomes could contribute to the success of the firm's root cause analysis and remediation efforts. Therefore, the proposed standard includes a note highlighting that it may be beneficial for firms to consider actions, behaviors, or conditions that resulted in positive outcomes, such as where aspects of the firm's QC system operated effectively or where no engagement deficiencies were identified for individual engagements.

In some circumstances, a firm may determine the root cause of a QC deficiency is related to the use of a resource or service provided by a third-party provider. If this were to occur, under the proposed standard, the firm would be responsible for addressing the effect of the deficiency on its QC system. This could include, among other things, working with the third-party provider to design and implement remedial actions or deciding to end the relationship with the third-party provider and, as part of the firm's remedial actions, revising its policies and procedures in the area affected. Irrespective of the approach taken and the extent of participation by third parties, the firm remains responsible for its QC system.

If a firm belongs to a network and uses network resources or services to enable the operation of the firm's QC system or the performance of its engagements, a root cause of a QC deficiency could be related to the network resource or service. Similar to a firm's use of resources or services provided by a third-party provider, a firm would be responsible for addressing the effect of the deficiency on its QC system regardless of whether the remedial actions taken by the firm are coordinated with the network or designed and implemented exclusively by the firm. Further, the firm remains responsible for determining whether the actions taken by the network sufficiently remediate the QC deficiency.

The concept release sought feedback on whether a future PCAOB standard should provide additional direction regarding firms' root cause analysis and remediation activities. Some commenters, including firms, thought additional direction was not necessary. One firm responded that root cause analysis will continue to evolve as firms adopt new technologies and new methods of performing audits in response to changes in their clients' business and the external environment. That commenter further cautioned that prescriptive requirements addressing root cause analysis could quickly become outdated and undermine the objective of establishing an effective continuous feedback loop. Another firm commented that the guidance in proposed ISQM 1 is sufficient and provides firms with the flexibility to determine appropriate procedures in these areas based on risk.

Several commenters were in favor of the PCAOB providing additional direction. One investor group was in favor of having prescriptive requirements, whereas the majority of the other commenters, including firms and related groups, suggested additional direction through guidance. One of these commenters responded that more direction would promote consistency regarding appropriate root cause analysis and remediation of QC deficiencies. That commenter also noted that examples of the Board's expectations regarding remediation based on the Board's experience and best practices related to root cause analysis (including how it could be scalable) may be helpful to firms who have not yet implemented such activities.

Under the proposed standard, firms are able to design their approach to conducting root cause analysis and developing remedial actions. Firms' approaches will vary based on the nature and circumstances of the firm and its engagements. In addition, approaches will likely change as new technologies become available and other techniques develop.

#### **I. Monitoring the implementation and operating effectiveness of remedial actions**

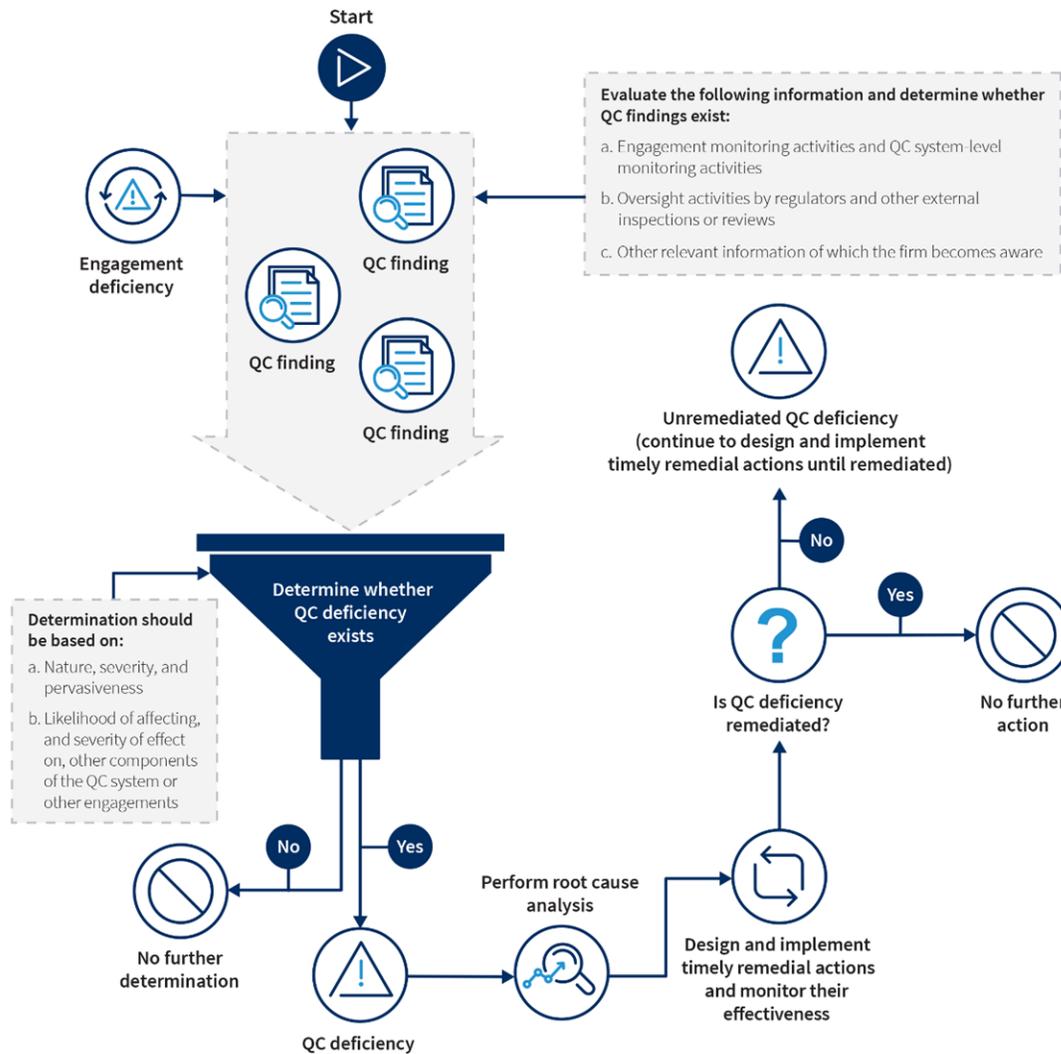
.76 The firm should monitor the implementation and operating effectiveness of remedial actions to address the *QC deficiency* and determine whether such actions are implemented as designed and operate effectively to remediate the *QC deficiency*. If those actions do not remediate the *QC deficiency*, the firm should take timely action until the *QC deficiency* is remediated.

A firm monitors the effectiveness of its remedial actions through engagement monitoring activities and/or QC system-level monitoring activities, depending on the nature of the QC deficiency. If a firm determines the remedial actions were not properly implemented or operating effectively, the firm would be required to take timely actions until the monitoring activities indicate the QC deficiency was remediated. Timely actions could include, among others, one or more of the following:

- Adjusting the implemented remedial actions;
- Designing and implementing additional remedial actions; or
- Performing additional root cause analysis to determine if other causes exist and, if so, designing and implementing remedial actions to address such causes.

Once additional actions are taken, a firm would perform monitoring activities on such changes to determine whether the QC deficiency was remediated.

### Determining the Existence of and Remediating QC Deficiencies



## 2. Current PCAOB standards

Current PCAOB QC standards require firms to establish policies and procedures to provide the firm with reasonable assurance that the policies and procedures relating to each of the other QC elements are suitably designed and are being effectively applied.<sup>265</sup> The standards also address how a firm implements the monitoring element of a QC system in its accounting

<sup>265</sup> See QC 20.20.

and auditing practice.<sup>266</sup> The standards discuss various monitoring procedures that a firm may perform, such as reviewing engagements before or after the engagement reports are issued, reviewing selected administrative and personnel records pertaining to the QC elements, considering systemic causes of findings that indicate improvements are needed, determining corrective actions, and following up to ensure that any necessary modifications are made to the firm's QC policies and procedures on a timely basis.<sup>267</sup> Although current PCAOB QC standards provide that monitoring procedures taken as a whole should enable firms to obtain reasonable assurance that their QC systems are effective,<sup>268</sup> there are no express obligations for firms to perform any specific types of monitoring.

Current PCAOB QC standards also provide that individuals may perform monitoring procedures over the same areas for which they are responsible.<sup>269</sup> Such monitoring procedures are a type of self-assessment. Under the proposed standard, self-assessments are not permissible, as individuals' objectivity would likely be impaired if they reviewed (1) engagements on which they participated or, in the case of audits, performed the engagement quality review, or (2) monitoring activities for which they participated in the design, implementation, or operation of the activity.<sup>270</sup>

### 3. Key differences from other QC standards

There are certain aspects of the proposed standard that go beyond the requirements or direction in other QC standards:

- Bifurcating QC monitoring activities into engagement monitoring activities and QC system-level monitoring activities.
- Including requirements related to monitoring in-process engagements.
- Defining engagement deficiencies and requiring firms to determine whether they exist.

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<sup>266</sup> See generally QC 30.

<sup>267</sup> See QC 30.03; QC 30.06.

<sup>268</sup> See QC 30.03.

<sup>269</sup> See QC 30.10.

<sup>270</sup> See proposed QC 1000.44e. (providing, as a resource quality objective, that firm personnel who are assigned to perform activities within the QC system have the objectivity to perform such activities). In these circumstances, the firm may use other participants or third-party providers to perform monitoring activities.

- Differences in defining QC deficiency.
- Approach to monitoring activities performed by a network.

## Questions

45. Are the proposed requirements for the monitoring and remediation process appropriate? Are changes to the requirements necessary for this process? If so, what changes should be made and why?
46. Is the proposed requirement to inspect engagements for each engagement partner on a cyclical basis appropriate? If not, why not?
47. Is it appropriate to require monitoring of in-process engagements by firms that issue audit reports with respect to more than 100 issuers during a calendar year? If not, is there a more appropriate threshold?
48. Are the purposes of in-process monitoring (as proposed within this standard) clear and appropriate, including how in-process monitoring differs from the requirements of engagement quality reviews under AS 1220? If not, what additional direction is needed?
49. Is it appropriate to require firms to consider performing monitoring activities on work they perform on other firms' engagements? If not, why not?
50. Are the proposed factors for firms to take into account when determining the nature, timing, and extent of engagement monitoring activities, including which engagements to select, appropriate? If not, what other factors should be specified?
51. Are the proposed factors for firms to take into account when determining the nature, timing, and extent of QC system-level monitoring activities appropriate? If not, what other factors should be specified?
52. Are the proposed requirements for firms that belong to a network that performs monitoring activities appropriate? If not, what changes should be made?
53. Are the proposed definitions for "engagement deficiency," "QC finding," and "QC deficiency" sufficiently clear and appropriate? If not, what changes should be made and why?
54. What, if any, additional direction is needed regarding:
- a. Evaluating information to determine whether QC findings exist;
  - b. Evaluating QC findings to determine whether QC deficiencies exist; or
  - c. Responding to engagement and QC deficiencies?
55. Should firm personnel be allowed to inspect engagements or QC activities in which they are involved? If so, please explain why and provide examples of mechanisms that could reduce

to an appropriate level the risk that noncompliance with PCAOB standards or the firm's policies and procedures would not be detected.

56. Are the proposed requirements related to monitoring and remediation sufficiently scalable for smaller firms? Are there aspects of the proposed requirements that could be further scaled?

## L. Evaluating and Reporting on the QC System

### 1. Proposed QC 1000

#### a. Annual evaluation of the effectiveness of the QC system

A firm's evaluation of the results of its monitoring and remediation process helps the firm identify the areas within the QC system that are designed, implemented, and operating effectively, as well as areas that require attention. This perspective could assist firm leadership in allocating resources to address QC deficiencies and would provide them with a basis for communicating to others—within or outside the firm—the status of the firm's QC system.

Our current QC standards do not require such an evaluation. We understand that some firms already evaluate their QC systems, either voluntarily or in response to other requirements.<sup>271</sup> However, not all firms evaluate their QC systems, and those that do may not apply the same degree of rigor.

.77 Annually, the firm must evaluate the effectiveness of its QC system, based on the results of its monitoring and remediation activities, and conclude, as of November 30 (the "evaluation date"), that its QC system:

- a. Is effective with no unremediated *QC deficiencies*; or
- b. Is effective except for one or more unremediated *QC deficiencies* that are not *major QC deficiencies*; or
- c. Is not effective (one or more *major QC deficiencies* exists).

Note: An unremediated QC deficiency is one for which remedial actions that completely address the QC deficiency have not been fully implemented, tested, and found effective.

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<sup>271</sup> See, e.g., *NYSE Listed Company Manual*, Section 303A.07(b)(iii)(A); Section 2(d) of Article 13, Regulation (EU) 537/2014.

The proposed standard would require the firm to evaluate its QC system annually as of November 30 and conclude on whether any unremediated QC deficiencies (including major QC deficiencies) exist as of that date. The evaluation would be based on data and evidence provided by the firm's monitoring and remediation activities. The standard includes a note clarifying what unremediated means in this context.

We believe this approach could highlight the importance of the QC system in driving continuous improvement in firms' ability to perform compliant engagements on a consistent basis. The evaluation requirement would drive firms to collect and analyze the results of their monitoring and remediation processes in order to identify deficiencies and would provide an additional incentive for firms to focus in areas requiring the most immediate attention and improvement.

We believe the evaluation requirement could also reinforce the responsibility and accountability of leadership for the firm's QC system.<sup>272</sup> As discussed in Section IV.C above, the individual charged with ultimate responsibility and accountability for the QC system as a whole would be accountable for the annual evaluation, and both that individual and the individual charged with operational responsibility and accountability for the QC system as a whole would be required to certify the firm's annual report regarding the evaluation of its QC system.<sup>273</sup> We believe this could send a clear message about the importance of the evaluation and incentivize firm leadership to take ownership of both the annual evaluation of the QC system and the results.

#### i. Evaluation requirement

The concept release sought feedback on whether a future QC standard should require firms to perform an annual evaluation of their QC systems' effectiveness. The majority of commenters, including firms and related groups, were supportive of requiring firms to perform such an evaluation.

The proposal includes a requirement for the firm to evaluate annually whether its QC system is effective, is effective except for one or more unremediated QC deficiencies that are not major QC deficiencies, or is not effective (i.e., one or more major QC deficiencies exists). Pursuant to paragraph .07c, firms that were not required to implement and operate a QC system within the previous 12 months would not be subject to the requirements to evaluate or report on their QC system.

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<sup>272</sup> See proposed QC 1000.13–.17.

<sup>273</sup> See proposed QC 1000.14c.-d. and .15b.

## ii. Evaluation frequency and date

Consistent with commenter input, we are proposing that firms perform an evaluation annually. An annual evaluation could provide leadership with timely information to facilitate an effective feedback loop.<sup>274</sup>

When asked whether commenters supported an evaluation as of a specified date or for a specified period, commenters, including firms, generally supported an evaluation as of a specified date. Some of those commenters provided additional support for their views by analogizing an “as of” evaluation date to the approach required for management’s annual report on internal control over financial reporting and auditor attestation of that evaluation.<sup>275</sup>

The concept release also requested commenter views on how the evaluation date or period should be determined. Several commenters, generally firms, suggested that a future standard should provide flexibility by letting firms decide their annual evaluation date. One firm noted that it may be appropriate for some firms to use an evaluation date that is consistent with their fiscal year end, while other firms may find it beneficial to set the date at a natural break in their monitoring cycle, which may not correspond with their fiscal year end. Some firms suggested an approach consistent for all firms where the evaluation date would align with their fiscal year end. Another commenter suggested that the evaluation date be based on a date consistent with annual reporting required by the PCAOB, such as the date firms are required to file their annual report on Form 2 (i.e., June 30). Two commenters cautioned against a specific date or period. Instead, they suggested a continuous, iterative evaluation throughout the year.

We considered commenter feedback and propose an evaluation date for all firms of November 30. Our proposed evaluation date is based on our understanding that many firms perform their internal inspections process during the second and third quarters, which allows them time to design and implement remediation efforts ahead of “busy season.”

### **b. Determining whether major QC deficiencies exist**

The proposed standard would require firms to evaluate unremediated QC deficiencies as of the evaluation date to determine whether major QC deficiencies exist. While the identification of QC deficiencies would be an ongoing process throughout the year, the determination of whether any of those QC deficiencies, alone or in combination, constitute

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<sup>274</sup> Firms could decide to evaluate the QC system more frequently than required under the standard. For example, a firm with one or more major QC deficiencies may decide to perform a mid-year evaluation to gauge the effectiveness of its remedial actions.

<sup>275</sup> See Items 308(a) and (b) of Regulation S-K, 17 C.F.R. § 229.308(a) and (b).

major QC deficiencies would be required only as part of a firm's annual evaluation of its QC system.

i. **Definition of a major QC deficiency**

The proposed standard defines a major QC deficiency as an unremediated QC deficiency or combination of unremediated QC deficiencies, based on the evaluation under paragraph .78, that severely reduces the likelihood of the firm achieving the reasonable assurance objective or one or more quality objectives. As with "QC deficiency," the proposed term "major QC deficiency" is analogous to a term in COSO's integrated framework (major deficiency).

The proposed standard's definition of a major QC deficiency provides for circumstances that are presumed to evidence a major QC deficiency. These circumstances include an unremediated QC deficiency or combination of unremediated QC deficiencies that:

- Relates to the firm's governance and leadership that affect the overall environment supporting the operation of the QC system. Firm governance and leadership establish the environment that determines how firm personnel carry out responsibilities for the operation of a firm's QC system and the performance of its engagements. Because of the pervasive impact of leadership and "tone at the top," one or more unremediated QC deficiencies related to firm governance and leadership that affect the overall environment supporting the operation of the QC system would almost always severely reduce the likelihood of the firm achieving the reasonable assurance objective or one or more quality objectives.
- Results in or is likely to result in one or more significant engagement deficiencies in engagements that, taken together, are significant in relation to the firm's total portfolio of engagements conducted under PCAOB standards. A significant engagement deficiency exists when (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB or failed to perform interim review or attestation procedures necessary in the circumstances, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.<sup>276</sup> An unremediated QC deficiency that would likely result in one or more of these deficiencies in engagements that, taken together, are significant in relation to the firm's total portfolio of engagements conducted under PCAOB standards would give rise to a presumption that a major QC deficiency exists. The definition includes examples of quantitative and qualitative criteria that may signal such significance.

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<sup>276</sup> See Notes to AS 1220.12, .17, .18B.

The circumstances where a major QC deficiency is presumed to exist are not an exhaustive list of possible major QC deficiencies. For example, any deficiency that requires significant effort and resources to remediate may be a major QC deficiency. Moreover, a presumption does not compel a conclusion that a major QC deficiency exists, although contrary information would be required to overcome it. When circumstances exist that are presumed to evidence a major QC deficiency but the firm concludes that it does not have a major QC deficiency, the firm would be required to disclose the basis for its determination in its report to the PCAOB on Form QC, as discussed further in Section IV.L.1.c below.<sup>277</sup>

## ii. Factors for consideration

To help firms make the determination of whether a major QC deficiency exists, the proposed standard provides factors on which to base the determination, which would assist firms in applying the definition and exercising professional judgment.

.78 As of the evaluation date, the firm must evaluate unremediated *QC deficiencies* to determine whether *major QC deficiencies* exist. The firm's determination should be based on the following factors:

- a. The severity and pervasiveness of the unremediated *QC deficiencies*, which may be evidenced by, for example:
  - (1) The number of components or *quality objectives* directly or indirectly affected by the unremediated *QC deficiencies*;
  - (2) The extent to which the unremediated *QC deficiencies* relate to a component, *quality objective*, or *quality response* that affects the design or operation of other components or *quality responses*;
  - (3) The number and pervasiveness of root causes underlying the unremediated *QC deficiencies*;
  - (4) The number of *engagements* that are affected by the unremediated *QC deficiencies* or are likely to be affected in the future if the *QC deficiencies* are not remediated;
  - (5) The number of *engagements* that may have unsupported opinions unless additional procedures are performed; and

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<sup>277</sup> See Appendix 2, Proposed Form QC, *Report on the Evaluation of the Firm's System of Quality Control*, Item 2.5.

(6) The number of *engagements* for which the firm revised and reissued its engagement report(s) because, after additional procedures were performed, the financial statements or management's report on internal control over financial reporting was restated or revised; and

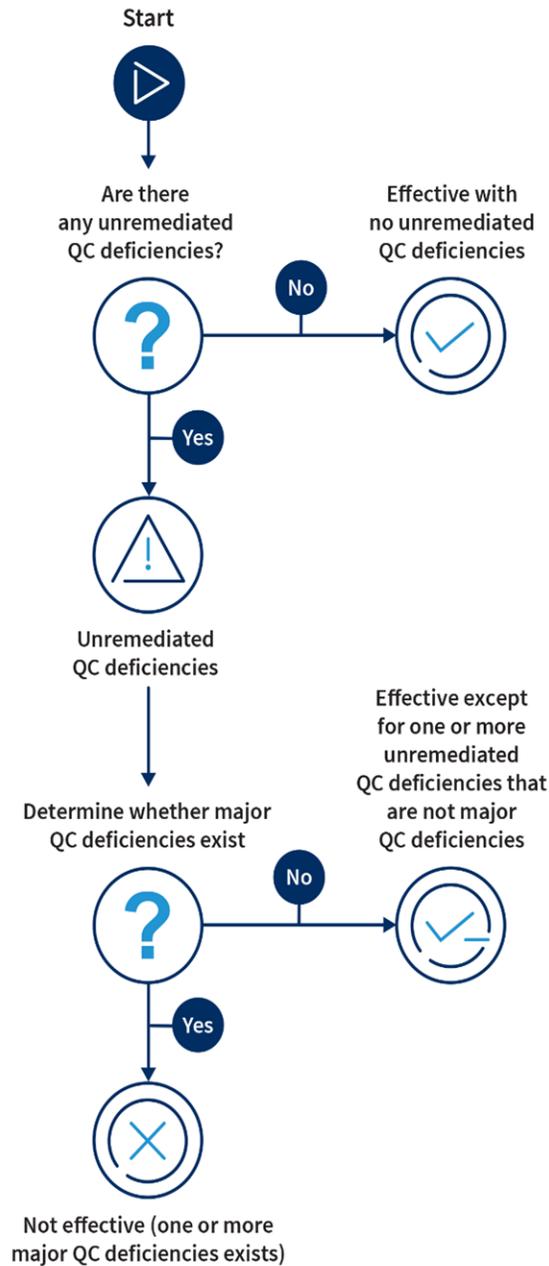
Note: In evaluating each unremediated *QC deficiency*, the firm would consider both quantitative and qualitative implications.

b. The extent to which remedial actions have been implemented, tested, and found to be effective.

Under the proposed standard, the factors for determining whether a major QC deficiency exists are:

- The severity and pervasiveness of the unremediated QC deficiencies. A firm would assess an unremediated QC deficiency, considering both quantitative and qualitative implications. For example, a firm would assess how many of the components of its QC system, quality objectives, and quality responses are affected by the deficiency, the number of root causes, and the number of affected engagements or engagements likely to be affected in the future, as well as the impact on those engagements, including engagements where the opinion was not appropriately supported or the financial statements or management's internal control assessment had to be revised or restated. The firm would also consider the implications of the deficiency for the QC system overall, based on ways in which the design or operation of other aspects of the QC system may be affected, the pervasiveness of the root causes, and the risk of the firm issuing inappropriate engagement reports or otherwise performing deficient engagements in the future. Viewed this way, for example, an unremediated QC deficiency that affects engagements only in a single industry, where the firm has few clients and no intention to acquire more and the engagements represent an insignificant portion of the firm's total portfolio of engagements under PCAOB standards, is less likely to be severe or pervasive.
- The extent to which remedial actions have been implemented, tested, and found to be effective. Before the annual evaluation date, a firm may implement remedial actions that may reduce the severity of an unremediated QC deficiency. To illustrate, if a firm identifies an issue with its audit software, it could develop a temporary "work around" to mitigate the unremediated QC deficiency until a permanent solution is employed. For this factor to be relevant for a firm when determining whether a major QC deficiency exists as of the annual evaluation date, the remedial actions have to be tested and the results have to show that such remedial actions are operating effectively.

### Annual Evaluation of the Firm's QC System



### iii. Example of major QC deficiency determination

*The following example is illustrative of certain of the considerations relevant to determining major QC deficiencies and is not intended to provide a complete description of the determination process.*

Suppose, in the revenue testing example discussed in Section IV.K.1.j.iii., the firm determined there was a QC deficiency as a result of the firm's methodology being out of date, which resulted in a failure to obtain sufficient appropriate audit evidence. Similar findings exist on other engagements in which the out-of-date methodology was used. If this QC deficiency is unremediated as of November 30, the firm would be required to evaluate whether it is a major QC deficiency.

The definition of major QC deficiency includes two presumptions—essentially, two scenarios that would generally result in a conclusion of major QC deficiency. The firm would initially determine whether a major QC deficiency would be presumed to exist under either or both of those scenarios.

- *The QC deficiency relates to firm governance and leadership that affect the overall environment supporting the operation of the QC system.* This presumption would arise if, for example, the out-of-date methodology was symptomatic of a broad failure by firm leadership to promote and reinforce the firm's commitment to quality through their actions and strategic decisions, including "tone at the top" and resource allocation decisions.
- *The QC deficiency results in or is likely to result in one or more significant engagement deficiencies in engagements that, taken together, are significant in relation to the firm's total portfolio of engagements conducted under PCAOB standards.* In the example, the QC deficiency reflected a failure to obtain sufficient appropriate audit evidence, which is a significant engagement deficiency. The presumption would arise if the out-of-date methodology results in or is likely to result in similar deficiencies in a significant portion of the firm's portfolio of engagements under PCAOB standards—for example, if the methodology is used in an industry sector that is responsible for a significant portion of the revenues or profits that the firm generates from engagements.

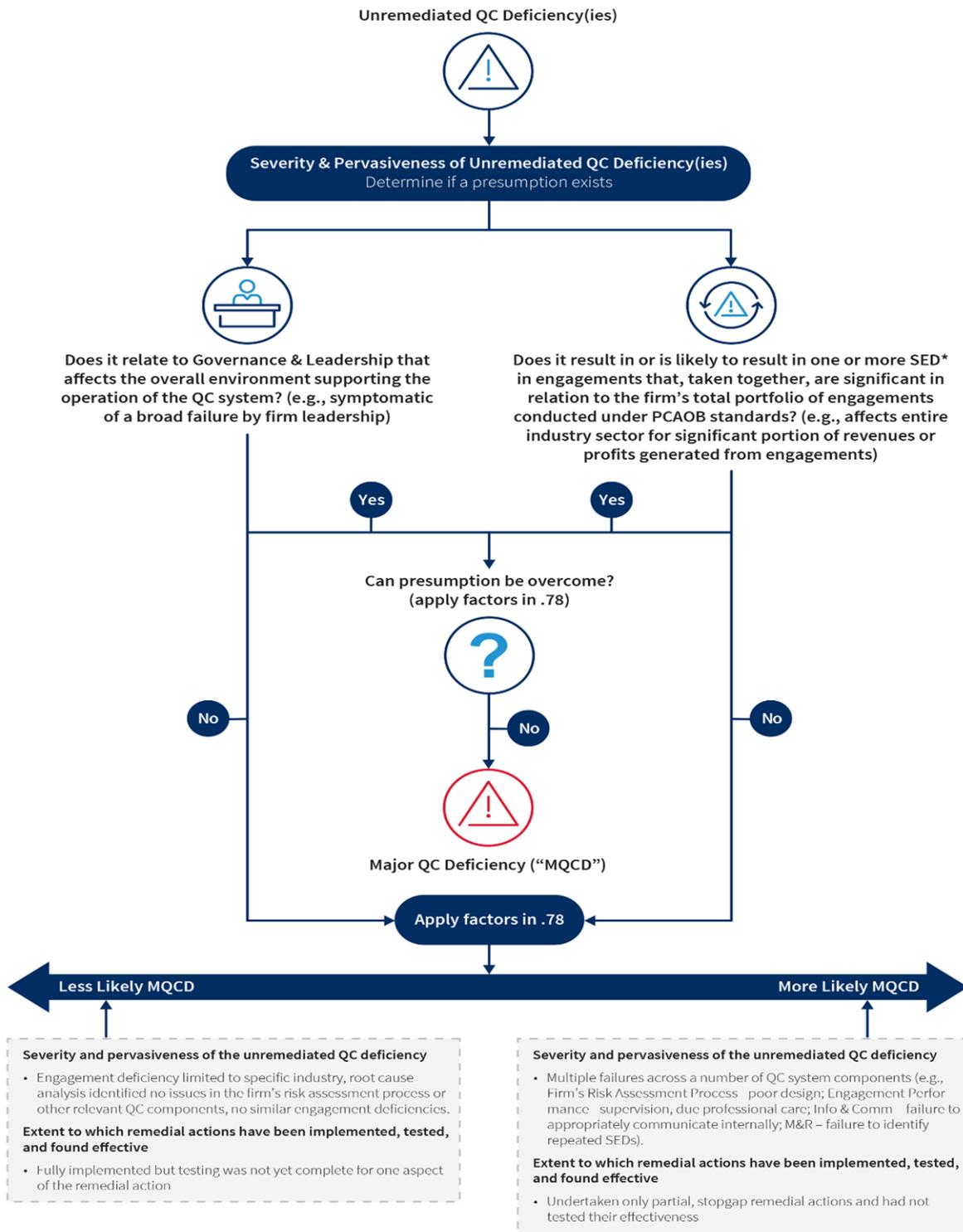
If a major QC deficiency is presumed to exist, then the firm would conclude that there is a major QC deficiency unless it can overcome the presumption by showing that, in the firm's particular circumstances, the unremediated QC deficiency does not severely reduce the likelihood of the firm achieving the reasonable assurance objective or one or more quality objectives. As discussed in Section IV.L.1.c below, the firm's rationale would have to be reported to the PCAOB on Form QC.

If no presumption arises that the unremediated QC deficiency is a major QC deficiency, the firm would determine whether the likelihood of achieving the reasonable assurance objective or one or more quality objectives has been severely reduced by applying the factors set out in paragraph .78: the severity and pervasiveness of the unremediated QC deficiencies and the extent to which remedial actions have been implemented, tested, and found effective.

In the revenue testing example, the firm could look to information from its monitoring and remediation activities, including root cause analysis, for relevant evidence in applying the paragraph .78 factors.

- *Severity and pervasiveness of the unremediated QC deficiency.* Suppose the firm had concluded that the deficiency in its revenue methodology was attributable to problems in more than one QC system component—for example, deficiencies in the firm’s risk assessment process regarding the implementation of a new audit standard that resulted in poor design; deficiencies in engagement performance related to supervision and the exercise of due professional care; deficiencies in information and communications, such that questions about the adequacy of the methodology were not communicated appropriately internally; and deficiencies in monitoring and remediation, such that repeated engagement deficiencies were not identified—and that a likely consequence of applying the methodology in the audit was that the audit report would not be supported by sufficient appropriate evidence. This sort of pervasive and severe failure would meet the definition of a major QC deficiency. Alternatively, suppose that the revenue methodology was deficient only as applied to a narrow fact pattern in a particular industry that did not affect all engagements in that industry, root cause analysis revealed no significant issues in the risk assessment process or the other relevant components of the QC system, and no similar engagement deficiencies had been identified. These considerations would make it less likely that a major QC deficiency exists.
- *Extent to which remedial actions have been implemented, tested, and found effective.* The firm would also consider the extent to which it had been able to remediate the QC deficiency. If the firm had undertaken only partial, stopgap remedial actions and had not tested their effectiveness or if the deficiency was identified close to the evaluation date and the firm had not yet taken remedial actions, that would make it more likely that a major QC deficiency existed. On the other hand, if the firm had fully implemented remedial actions (for example, developed a corrected methodology, deployed an updated training program for all affected firm personnel, and communicated firm methodology changes to all firm personnel) but testing was not yet complete for one aspect of the remedial action, that could make it less likely that a major QC deficiency exists.

Example of Considerations Relevant to Determining Major QC Deficiency



\*SED - Significant engagement deficiency. A significant engagement deficiency exists when (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB or failed to perform interim review or attestation procedures necessary in the circumstances, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

### c. Firm reporting on QC system evaluation

The concept release sought comment on different reporting requirements regarding firms' annual evaluation of the QC system, including reporting publicly or to the PCAOB, and also asked whether such reports should be certified by the firm's leadership.

#### i. Reporting to the PCAOB: proposed Form QC

.79 The firm must report annually to the PCAOB on Form QC, in accordance with the instructions to that form, the results of the evaluation of its QC system not later than January 15 of the year following the evaluation date.

.80 The contents of the firm's reporting to the PCAOB must include the following:

a. The firm's conclusion that, as of the evaluation date, the firm's QC system:

- (1) Is effective with no unremediated *QC deficiencies*;
- (2) Is effective, except for one or more unremediated *QC deficiencies* that are not *major QC deficiencies*; or
- (3) Is not effective (one or more *major QC deficiencies* exists).

b. If the firm reports a conclusion under .80a.(2) or .80a.(3), a description of each unremediated *QC deficiency*, including each *major QC deficiency*, consisting of:

- (1) The requirements of this standard or the *quality objective(s)* to which it relates;
- (2) The firm's basis for determining it was a *QC deficiency* as of the evaluation date; and
- (3) A summary of the remedial actions taken and planned to be taken to address the *QC deficiency*, as well as the timing and the status of such actions, including a summary of actions taken or to be taken by the firm to address the risk that the *QC deficiency* resulted or could result in the issuance of unsupported engagement reports.

c. If a *major QC deficiency* is presumed to exist but the determination was made that there is no *major QC deficiency*, the basis for such determination.

In the concept release we sought feedback on whether a future QC standard should include a requirement for firms to report annually to the Board. Some commenters, including a firm and an individual, supported firms directly reporting to the Board. Several commenters stressed the importance of the PCAOB maintaining the confidentiality of such information if the proposed standard would require this reporting. Several firms, as well as other commenters, were not supportive of a reporting requirement. Some of these commenters did not think reporting was necessary or considered it duplicative, since a firm's evaluation would be available to PCAOB staff upon inspection.

We propose requiring firms to report to the Board annually the outcome of the evaluation of the firm's QC system with respect to any period during which the firm was required to implement and operate the QC system. We believe that annual reporting to the Board would provide the PCAOB with important information about firm QC systems in a timely and structured way and would provide an effective and efficient means of gathering information about the QC systems. Data collected by the PCAOB would inform our inspections process, including decisions about the selection of firms and engagements as well as focus areas to inspect and the nature and extent of our inspection procedures (both for QC processes and individual engagements), and could enable us not only to make more refined data requests from the firms, but also to focus our inspection resources on those firms and engagements with the greatest risk. Additionally, we believe that a formal reporting process may result in enhanced accountability of firm leadership for QC and an additional incentive for prompt remediation of identified QC deficiencies.

The proposed contents of Form QC would address the matters listed in paragraphs .79-.80. In addition, proposed Form QC would elicit certain information about the firm and the individuals responsible for the QC system, aggregated information about the items required to be reported in accordance with paragraph .80, the areas of QC to which any unremediated QC deficiencies relate, and a certification of the evaluation of the QC system by certain designated individuals (discussed in Section IV.L.1.c.iii.).

In developing this proposal, we considered several alternatives, including requiring firms to report to the Board on the outcome of the annual evaluation of the firm's QC system only when the firm identifies a major QC deficiency. While this approach could reduce some of the costs associated with preparing the annual evaluation to the PCAOB, it would also significantly reduce the value of the proposed reporting of the firm's annual evaluation to the PCAOB. As noted above, reporting on unremediated QC deficiencies would inform various aspects of our oversight activities. In addition, to the extent that reporting may increase firm leadership's focus on their responsibility and accountability for quality, reduced reporting would be less beneficial. Therefore, we preliminarily believe that annual reporting to the PCAOB of the results of firms' annual evaluation of the QC system is the appropriate approach.

We do not expect the incremental effort for a firm to report its evaluation to the PCAOB would be substantial, as the firm would be communicating the results of its evaluation process and any related remediation activities that it would already have been required to conduct and document. Reporting to the PCAOB would be done using the same platform as our other reporting forms (currently, our web-based RASR system and, in the future, potentially new means of information exchanges as the PCAOB continues to modernize its reporting technology aimed at simplifying and automating data collection, processing, and interoperability).

We are proposing that firms report their evaluation on a new form, Form QC. The proposed text of Form QC, together with the proposed form instructions, is attached as part of Appendix 2.

We are proposing a filing deadline for this reporting of January 15 of the year following the evaluation date. The proposed deadline is consistent with the proposed date for firms to assemble a complete and final set of documentation related to their QC system, as discussed in Section IV.M. below.

#### ii. Proposed Form QC: not publicly available

The concept release noted we were considering the extent to which the information in an annual report to the PCAOB on the firm's evaluation of the effectiveness of its QC system should be publicly available. Some firms produce publicly available transparency reports, which report on audit quality, either voluntarily or in response to the requirements of other jurisdictions. Several commenters, generally investors and investor advocates, were supportive of the PCAOB requiring some level of public reporting about firms' QC systems. Some commenters suggested that such U.S. reporting would be similar to audit quality reports required by certain jurisdictions, such as reports required by the European statutory audit regulations.<sup>278</sup> Some commenters highlighted the benefits of public reporting, including increased transparency and accountability. Some of these commenters noted that investors would particularly benefit from public reporting and one commenter cited improving investor confidence.

Several commenters, generally firms and related groups, opposed a requirement for firms to make reports on their QC systems' effectiveness publicly available. Some suggested that required reporting was not necessary since many firms already produce reports that include a discussion of the firm's QC initiatives. Some firms, along with other commenters, stated that public disclosure may not be consistent with PCAOB Rule 4009<sup>279</sup> or may result in unintended consequences (e.g., litigation risk, confusion, or a "checklist approach"). One firm

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<sup>278</sup> See Article 13 of Regulation (EU) 537/2014.

<sup>279</sup> PCAOB Rule 4009 addresses the PCAOB's approach to inspection reports that contain criticisms of, or potential defects in, a firm's QC system.

expressed concern that public disclosure would create additional costs for firms without providing a benefit to investors and other stakeholders. The same firm also stated that unlike a registrant's report on ICFR, which is specific to that registrant, a firm's disclosure about its QC system is broader and not specific to a particular engagement and, therefore, may not provide investors with information useful for their investment decisions. A firm and a group representing companies indicated that the current public disclosure system addressed through inspection reports and other information is sufficient.

Some firms and a related group suggested that firms' public disclosure about their QC systems should be voluntary and market-driven. They suggested this approach would enable firms to tailor their reporting based on, for example, the nature of the firm, the relevant issues that might be presented, what each firm believes is important to measure, and the interests of the firm's external stakeholders.

We recognize the desire of investors and other stakeholders for information related to audit quality and the effectiveness of firms' QC systems. But our ability to require firms to publicly disclose their QC deficiencies is subject to certain legal constraints imposed by Sarbanes-Oxley.

As a threshold matter, some or all of the unremediated QC deficiencies identified during a firm's annual evaluation may have been identified as QC criticisms or potential defects during a PCAOB inspection.<sup>280</sup> Furthermore, we believe that the QC deficiencies we identify during our inspections are likely to be important information from the perspective of investors and other stakeholders, especially because our inspection teams customize their QC-related procedures based on, among other things, the firm's structure, procedures performed in prior inspections, past and current inspection observations, the size of the firm, and an assessment of risk related to each focus area. Notably, however, Section 104(g)(2) of Sarbanes-Oxley provides that if a quality control criticism or potential defect identified during a PCAOB inspection is addressed by the firm to the Board's satisfaction within 12 months of the date of the Board's inspection report, no portions of the inspection report that deal with that criticism or potential defect will be made public.<sup>281</sup> Therefore, making or requiring public disclosure, through a publicly available form, of QC deficiencies that have been identified during a PCAOB inspection and that are subject to the 12-month statutory remediation period would be inconsistent with this provision of Sarbanes-Oxley.

This limitation imposed by Section 104(g)(2) appears to be a significant one. . In light of Section 104(g)(2), it appears that even if the PCAOB were to require Form QC to be publicly available, the PCAOB could not require the disclosure of information regarding the existence or nature of QC deficiencies that are still subject to the 12-month remediation period. The

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<sup>280</sup> See proposed QC 1000.71b.

<sup>281</sup> See Section 104(g)(2) of Sarbanes-Oxley, 15 U.S.C. § 7214(g)(2); see also PCAOB Rule 4009.

omission of such deficiencies would result in a publicly available Form QC that supplies an incomplete, potentially confusing, and potentially misleading picture of the effectiveness of the firm's QC system.

Moreover, public disclosure of portions of Form QC may in some cases be subject to other legal constraints imposed by Sarbanes-Oxley. Depending on how a QC deficiency has come to light, certain information contained within a Form QC might be confidential pursuant to Section 105(b)(5)(A) of Sarbanes-Oxley, which addresses documents and information prepared or received by or specifically for the Board in connection with an inspection or investigation.<sup>282</sup> Furthermore, proposed Form QC would require firms to report on remedial actions that in certain (though likely rare) circumstances may be subject to laws relating to the confidentiality of proprietary, personal, or other information, or might reasonably be identified by a firm as proprietary. In such a scenario, the Board, in accordance with Section 102(e) of Sarbanes-Oxley, would need to honor a firm's properly substantiated request for confidential treatment of such information.<sup>283</sup>

We do not believe that making incomplete, potentially confusing, and potentially misleading Form QCs public would be in the interests of investors or other stakeholders, who depend on the accuracy and completeness of such information to guide their decision-making. Furthermore, we believe firms may be in a better position to report fully and candidly to the PCAOB about their annual evaluation—more effectively supporting both their own remediation efforts and our oversight activities—if they are confident that the information would be understood and used in the context of a broader understanding of their overall audit practice and an ongoing dialogue between the firm and the PCAOB.

Accordingly, we are proposing that Form QC be nonpublic. To that end, we are proposing new PCAOB Rule 2203A, included in Appendix 2, which would establish the Form QC reporting requirement and would specify that the Board will not make a filed Form QC or the contents thereof (including any amendment thereto) public.<sup>284</sup> The proposed rule would not,

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<sup>282</sup> See Section 105(b)(5)(A) of Sarbanes-Oxley, 15 U.S.C. § 7215(b)(5)(A).

<sup>283</sup> See Section 102(e) of Sarbanes-Oxley, 15 U.S.C. § 7212(e); PCAOB Rule 2300(b).

<sup>284</sup> Sections 102(b)(2) and (d) of Sarbanes-Oxley authorize the Board to adopt rules requiring firms to periodically update the information contained in their registration applications or provide to the Board information as necessary or appropriate in the public interest or for the protection of investors. See Section 102(b)(2)(D), (b)(2)(H), and (d) of Sarbanes-Oxley, 15 U.S.C. § 7212(b)(2)(D), (b)(2)(H), and (d). Section 102(e) of Sarbanes-Oxley, in turn, permits the Board to designate in its rules the portions of registration applications and annual reports that will be made available for public inspection (subject to applicable laws relating to the confidentiality of proprietary, personal, or other information, and provided that the Board shall protect from public disclosure information reasonably identified by the firm as proprietary information). See Section 102(e) of Sarbanes-Oxley, 15 U.S.C. § 7212(e); see also

however, prohibit a firm from voluntarily disclosing its Form QC or the contents thereof to the public or to particular stakeholders. Nor would the proposed rule prohibit us from sharing Form QCs with the SEC or other entities, consistent with Sarbanes-Oxley.<sup>285</sup> The proposed rule expressly provides that Form QCs and their contents may be publicly disclosed in enforcement proceedings.<sup>286</sup> The proposed rule also provides that the Board may publish Form QC information in summaries, compilations, or other general reports, provided that the firm or firms to which particular Form QC information relates is not identified (unless the information has previously been made public by the firm or firms involved or by other lawful means).

We are not proposing, but soliciting comment on whether, in lieu of proposed Form QC, reporting on the evaluation of the QC system should be done through a non-public portion of the annual report on Form 2. It might be administratively simpler to use an existing form that is already required to be completed annually. However, Form 2 would become longer and more complex. Further, it might increase the complexity of reporting if there are different people collecting, reporting, and signing each part of the form. Additionally, because Form 2 reports information as of March 31 and is due on June 30, including QC reporting in Form 2 would change the evaluation and filing date and may create additional workload during many firms' "busy season." While Form 2 information currently is publicly available (subject to firms' ability to request confidential treatment), the Board can designate portions of the form as confidential.

While our preliminary view is that firm reporting on Form QC should be nonpublic due to both Sarbanes-Oxley's legal constraints and policy considerations, we note that other aspects of our proposal are intended to promote transparency about firm QC systems within the confines of those constraints.

For example, we have observed the emerging practice of firm transparency reporting, including that the nature and content of these reports continues to evolve and expand in response to market demand. Advances in thinking about firm and engagement performance metrics could also affect what financial statement users demand and what firms could usefully provide. As discussed above in Section IV.K.1.f, some commenters noted that more research is

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PCAOB Rule 2300(a)(2) (providing that forms filed pursuant to Part 1 or Part 2 of Section 2 of the Board's rules will be publicly available "except to the extent otherwise specified in the Board's rules or the instructions to the form").

<sup>285</sup> See, e.g., Section 105(b)(5)(B) of Sarbanes-Oxley, 15 U.S.C. § 7215(b)(5)(B).

<sup>286</sup> On proposed Form QC, firms may elect to request notification from the Board if the Board is requested by legal subpoena or other legal process to disclose information contained in Form QC. The Board will make reasonable efforts to honor such a request. This notification process does not apply to the PCAOB's or the SEC's use of Form QC or its contents in an enforcement proceeding, because those scenarios do not involve Board disclosure of Form QC information in response to a legal subpoena or other legal process.

necessary before a universal set of performance measures can be established. Another commenter noted that relevant metrics will continue to evolve with changes in businesses and technologies, further emphasizing the difficulty in establishing a common set of metrics to be applied by all firms. While we are not proposing public reporting of any standardized performance metrics, as discussed in Section IV.J above, we are proposing that the QC system would operate over any public reporting that firms do provide, including any public reporting of performance metrics. Firms would have to establish a specific quality objective with regard to their public reporting, including that any engagement-level or firm-level information communicated to external parties be accurate and not misleading, and—as with any quality objective—would have to monitor their performance in relation to that objective and remediate identified deficiencies.

Additionally, as discussed in more detail below, because the audit committee provides oversight of the auditor and the audit process, we are proposing to require communication to audit committees about the firm’s evaluation of its QC system.

We are also proposing that, as part of their annual reporting on Form 2, all registered firms would be required to provide an annual confirmation with regard to the design of their QC system and whether they were required to implement and operate the QC system. See Section V.C for a discussion of the proposed amendments to Form 2 and Appendix 5 for the text of the proposed amendments. We believe an annual confirmation would be a useful reminder to all firms of their responsibilities regarding the design, implementation, and operation of an effective QC system. We also believe that the public may benefit from being able to determine whether a particular firm has been required to implement and operate its QC system from year to year. Such information on Form 2 would be publicly available on our website and would be accessible to investors and other financial statement users, audit committees, and other stakeholders. It could also inform our oversight efforts.

To accompany the proposed changes to Form 2, we are also proposing to add a similar confirmation to the application for PCAOB registration, Form 1. We believe such a confirmation may appropriately put applicants on notice of their obligations with respect to their QC systems, which would apply from and after the time that their registration is approved. See Section V.C for a discussion of the proposed amendments to Form 1 and Appendix 5 for the text of the proposed amendments.

### iii. Certification of the evaluation of the firm’s QC system by firm leadership

The concept release sought comment on whether a firm’s leadership should certify the evaluation of its QC system’s effectiveness. Some commenters, including investors, supported requiring firm leadership’s certification. Some of these commenters analogized the certification of effectiveness to the certifications provided, pursuant to Sarbanes-Oxley, by an issuer’s

principal executive and financial officer on financial and other information contained in the issuer's quarterly and annual reports.<sup>287</sup>

Several commenters, generally firms, opposed a potential requirement for firm leadership to certify the effectiveness of its QC system. Some of these commenters stated that it would not add value or improve audit quality.

One firm supported the objective of reinforcing leadership's responsibility and accountability for quality but suggested requiring internal certification of the firm's QC system effectiveness, both for top leadership and other professionals involved in the QC system. The firm suggested that an internal certification process could contribute to audit quality because it would create greater accountability for professionals involved in the firm's QC system and serve as another incentive for firms to devote adequate resources and attention to the system's design, implementation, and operation.

We are proposing a requirement that both the individual assigned ultimate responsibility and accountability for the QC system as a whole and the individual assigned operational responsibility and accountability for the firm's QC system as a whole certify the firm's report to the PCAOB on the evaluation of its QC system.<sup>288</sup> We believe that, analogous to the CEO and CFO certifications required under Sarbanes-Oxley, such certification would lead to increased discipline in the evaluation process and would reinforce the accountability of the certifying officers. We are not proposing to require similar certifications from other personnel in the QC system, but firms may choose to institute policies requiring them.

The text of the proposed certification appears in Item 3.2 of proposed Form QC, contained in Appendix 2. That item would require certification of certain information regarding the design and evaluation of a firm's QC system, including that each certifying individual reviewed the Form QC and that the disclosures made in the Form QC are complete and

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<sup>287</sup> Under SEC rules adopted pursuant to Section 302 of Sarbanes-Oxley, CEOs and CFOs of issuers are required to certify, for each quarterly or annual report of the issuer, among other things, that (1) they have reviewed the report; (2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made not misleading; (3) based on the officer's knowledge, the financial statements and other financial information included in the report fairly present in all material respects the financial condition and results of operations of the issuer; (4) they (a) are responsible for establishing and maintaining internal control over financial reporting, (b) have designed ICFR to ensure that material information is made known to them, (c) have evaluated the effectiveness of ICFR, and (d) have presented their conclusions about the effectiveness of ICFR in the report; and (5) they have disclosed to the issuer's auditors and audit committee any significant deficiencies in ICFR and any fraud involving management or others involved with ICFR. See Exchange Act Rules 13a-14(a), 15d-14(a), 17 C.F.R. §§ 240.13a-14(a), 240.15d-14(a).

<sup>288</sup> See proposed QC 1000.14d and .15b.

accurate in all material respects to the individual's knowledge. The proposed certification would not contain the outcome of the firm's annual evaluation of its QC system or identify any unremediated QC deficiencies, but rather would certify the completeness and accuracy of that information. That information would be set forth elsewhere in Form QC and, as explained above, we propose to treat that information as nonpublic. Because we propose to treat the certified information as nonpublic, we likewise propose to treat the Item 3.2 certifications as nonpublic; in our preliminary view, the certifications would not present a full or useful picture of a firm's QC system without the underlying information.

#### iv. Reporting to the audit committee

In commenting on the concept release, two firms suggested that we consider having firms report to audit committees as a means of increasing transparency about QC systems. One of these firms commented that the public interest would be best served by having audit committees consider this information as part of executing their responsibilities for hiring, retaining, compensating, or terminating the audit firm. The other suggested we consider whether there was value in incremental communications with the audit committee about quality matters specific to the engagement, or if applicable, to promote a dialogue about matters addressed in the firm's published QC report.

We are persuaded that enhanced communication to the audit committee about the firm's QC system could enhance audit committee oversight. It could provide potentially valuable information about the firm and greater insight into the audit process, in a context that fosters dialogue and a more nuanced understanding of the firm's QC evaluation than public reporting would permit. Accordingly, we propose to amend AS 1301, *Communications with Audit Committees*, to require the auditor to communicate to the audit committee about the firm's most recent annual evaluation of its QC system. As discussed further in Section V.C below, the proposed communication requirement would not require a firm to disclose nonpublic information about the results of a PCAOB inspection and any necessary remediation by the firm that is subject to confidentiality restrictions under Section 105(b)(5)(A) of Sarbanes-Oxley.

## 2. Current PCAOB standards

Current PCAOB QC standards do not require firms to evaluate their QC systems or to report on any such evaluations. As previously noted, some firms conduct evaluations and share their results in published reports, either voluntarily or under other regulatory requirements.

## 3. Key differences from other QC standards

There is no term in either ISQM 1 or SQMS 1 that is analogous to major QC deficiency, and there are no reporting requirements, other than the requirement to communicate with those charged with governance. Accordingly, there is no requirement in either ISQM 1 or SQMS

1 for firms to determine and report if a major QC deficiency exists. However, in many instances, we believe a firm concluding that its QC system has one or more major QC deficiencies, as we propose to define that term, would be analogous to a firm concluding under either ISQM 1 or SQMS 1 that its system of quality management does not provide the firm with reasonable assurance that the objectives of the system of quality management are being achieved. However, there may be circumstances in which a firm would conclude under QC 1000 that its QC system was ineffective, but still view its QC system as providing reasonable assurance for purposes of other QC standards.

## Questions

57. Is November 30 an appropriate evaluation date for firms to conclude on the effectiveness of the QC system? Is there another specific date that would be more appropriate and if so, what date? Should firms be permitted to choose their own evaluation date?
58. Is the proposed definition of “major QC deficiency” clear and appropriate? If not, what changes should be made and why?
59. Is it appropriate to include in the proposed definition circumstances when a major QC deficiency is presumed to exist? Are the circumstances described in the proposed definition appropriate? Should there be other circumstances that give rise to such a presumption? If so, what are they?
60. Are the proposed factors for determining whether an unremediated QC deficiency is a major QC deficiency appropriate? If not, what other factors should be specified?
61. Should firms be required to report on the evaluation of the QC system to the PCAOB? If not, why not?
62. Should we require individual certifications of the evaluation of the QC system? Is the language in Appendix 2 regarding the certifications appropriate? If not, why not?
63. Is the proposed date for reporting on the evaluation of the QC system (January 15) appropriate? Is there another specific date that would be more appropriate and if so, what date? Is 45 days after the evaluation date an appropriate reporting date?
64. Rather than reporting on Form QC, should firms report on the evaluation of the QC system, as of March 31 on a non-public portion of Form 2, which is due on June 30?
65. Is the information required on proposed Form QC in Appendix 2 appropriate? Why or why not?
66. Are proposed Rule 2203A, *Report on the Evaluation of the Firm’s System of Quality Control*, and the proposed Form QC instructions included in Appendix 2, clear and appropriate? If not, why not?

67. Are there any non-U.S. laws that would prohibit reporting the information required about the firm's QC system to the PCAOB on Form QC?

68. Some of the PCAOB's reporting forms are permitted to be filed in XML format. Should we permit proposed Form QC to be filed in XML or another machine-readable format? Why or why not?

69. In light of the legal constraints of Sarbanes-Oxley with respect to public reporting regarding QC matters, are there other public reporting alternatives that should be considered? What would be the potential costs and benefits of such alternatives?

70. Are the proposed amendments to AS 1301 that require the auditor to communicate to the audit committee about the firm's most recent annual evaluation of its QC system appropriate? If not, why not?

### M. Documentation

Documentation supports a firm's QC system in a number of ways. It helps provide clarity around roles and responsibilities and the firm's policies and procedures, which promotes consistent compliance by firm personnel and other participants. Documentation enables proper monitoring and supports the evaluation and continuous improvement of a firm's QC system. It makes it easier to train firm personnel and other participants and facilitates the retention of organizational knowledge, providing a history of the basis for decisions made by the firm about its QC system. Further, documentation assists others conducting reviews of the firm's QC system by providing evidence of the system's design, implementation, and operation. Current PCAOB standards provide only general direction on the nature and extent of QC documentation and specific requirements for documentation of certain items.<sup>289</sup>

Through our oversight activities, we have observed that the nature and extent of firms' documentation of their QC systems varies greatly. Some firms have detailed documentation for all areas of their QC systems. Other firms have significantly less documentation. For example, some firms have documentation only in areas that have been subject to PCAOB inspections, such as remediation, root cause analysis, or internal inspections. Proposed QC 1000 would establish more comprehensive requirements for firms to document their QC systems.

In the concept release, we explored the possibility of using ISQM 1 as a basis for documentation requirements while layering in concepts from AS 1215, *Audit Documentation*. Some commenters, including firms, suggested that the PCAOB adopt the ISQM 1 requirements with minimal or no incremental or alternative requirements, in some cases expressing concern that the costs of incremental requirements would not be justified. Other commenters, including

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<sup>289</sup> See, e.g., QC 20.21, .24-.25.

a firm and a related group, supported using the ISQM 1 requirements along with the incremental requirements outlined in the concept release.

### 1. Proposed QC 1000

.81 The firm must prepare and retain documentation of the design, implementation, and operation of the QC system and of the annual evaluation of the QC system.

The proposed standard includes an overarching documentation requirement that would capture the design, implementation, and operation of the firm's QC system and the annual evaluation of the QC system.

The documentation of the design and implementation would capture decisions made regarding "the who, what, when, where, and why" of the QC system. This aspect of documentation would help firm personnel and others understand what is expected of them in fulfilling their responsibilities and support a consistent implementation and operation of the firm's QC system. For example, documentation of the design of policies and procedures regarding general and specific independence matters would enable a consistent understanding by firm personnel and others about who is responsible for what, when the responsibilities are triggered, and why certain actions are necessary.<sup>290</sup> Such documentation would also allow for consistent actions by firm personnel and others in implementing the design of those policies.

The documentation of the operation of the firm's QC system would enable the firm to determine if the policies and procedures were operated in the manner that the firm intended.<sup>291</sup> This specific documentation requirement would also provide evidence of compliance with the specified quality responses and other proposed requirements of QC 1000. For example, it would provide evidence of how the firm complied with specific communication requirements related to the operation of the firm's QC system and the performance of its engagements<sup>292</sup> and whether the procedures implemented by the firm were operated as designed.

.82 Documentation must include descriptions of the following matters:

- a. Lines of responsibility and supervision within the firm's QC system at successive senior levels up to and including the principal executive officer(s) or equivalent.

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<sup>290</sup> See e.g., QC 1000.33-.34.

<sup>291</sup> Firms that are not required to implement and operate the QC system would not be expected to have anything to document with respect to the operation of the QC system.

<sup>292</sup> See e.g., QC 1000.55-.57.

- b. Regarding the firm's risk assessment process:
- (1) *Quality objectives*;
  - (2) *Quality risks* related to the established *quality objectives* and the basis for the assessment of *quality risks*; and
  - (3) *Quality responses* and how the firm's *quality responses* are designed to address the *quality risks*.
- c. Regarding the monitoring and remediation process:
- (1) The *engagement* and QC system-level monitoring activities performed, including, if applicable, monitoring activities performed by the network;
  - (2) If a firm determines an *engagement deficiency* exists but that there is sufficient appropriate audit evidence to support the auditor's opinion, the basis to support the firm's determination;
  - (3) Actions taken to address *engagement deficiencies* pursuant to paragraphs .68 and .69;
  - (4) The evaluation of *QC findings* to determine whether *QC deficiencies* exist and the basis for each determination; and
  - (5) Root cause analysis and remedial actions to address identified *QC deficiencies* and the monitoring activities performed to evaluate the implementation and operating effectiveness of such remedial actions.
- d. Regarding the evaluation of the firm's QC system, the basis for the conclusion reached pursuant to paragraph .77.
- e. If the firm belongs to a network that provides or requires the use of resources or services in the firm's QC system or the performance of the firm's *engagements*, or uses resources or services obtained from a *third-party provider*:
- (1) The firm's understanding of how the resources or services used by the firm are developed and maintained;
  - (2) If the firm supplemented or adapted such resources or services, how and why they were supplemented or adapted; and
  - (3) How the firm implemented and operated such resources or services.

The proposed standard includes a list of specific matters that firms would be required to document. Documentation of the lines of responsibilities and supervision within the QC system would reduce operational ambiguity and provide clarity about who within the firm is accountable for various firm supervisory responsibilities within the firm's QC system.

The proposed requirement for the firm to document aspects of its risk assessment process would provide evidence that supports the annual risk assessment. Specifically, it would provide evidence of identified quality risks, reasons these risks were identified, and policies and procedures the firm had put in place in response. This documentation would be valuable in subsequent risk assessments and could help to support decisions about whether to modify quality objectives, quality risks, or quality responses.

The proposed requirements for the firm to document aspects of its monitoring and remediation process would provide evidence that supports its monitoring and remediation activities. For example, a firm's documentation of engagement and QC system-level monitoring activities performed, its evaluation of the results of those monitoring activities, actions taken to address engagement deficiencies, and identified QC deficiencies would demonstrate the firm's approach to complying with certain requirements of the proposed standard for the monitoring and remediation process component. This documentation would also assist the firm in monitoring its monitoring and remediation process and in making its annual evaluation of the effectiveness of the QC system pursuant to paragraph .77.

The proposed standard would also require the firm to document the basis for the conclusion it reached in evaluating the effectiveness of its QC system pursuant to paragraph .77. This documentation would provide evidence of the decisions made in reaching the conclusion about the effectiveness of the firm's QC system, which may be valuable in future evaluations.

In the concept release, we stated that we were also considering incremental or additional requirements to ISQM 1 for the firm to document its understanding of methodologies and tools provided by a network or third party, including how such methodologies and tools are responsive to the requirements of the professional standards and applicable legal and regulatory requirements. Some commenters supported specific documentation requirements related to network and third-party resource providers. Others, generally firms, stated that such incremental requirements are not necessary because they would already be addressed by the principles-based requirements in ISQM 1. One of these commenters was concerned that any incremental requirements could place a greater burden on firms that benefit from using these resources.

The proposed standard would require the firm to document certain matters if the firm uses resources or services provided by a network or a third-party provider in the firm's QC system or the performance of the firm's engagements. When a firm uses resources or services provided by a network or a third-party provider, the proposed standard would require the firm

to document how the resources or services are developed and maintained, and if such services or resources were supplemented or adapted, how they were supplemented or adapted and why. Firms would also have to document how the resources or services were implemented and operated. Documenting such matters would serve as the evidence of decisions made regarding resources or services used by the firm.

Some networks or third-party providers may provide documentation about their services or resources to firms. For example, the firm may obtain an understanding of how the resources were developed and maintained by the network through documentation provided by the network. This documentation may need to be supplemented by the firm depending on various factors, including the extent of the documentation provided and whether the firm supplements or adapts the resource or service.

.83 The documentation must be in sufficient detail to:

- a. Support a consistent understanding of the QC system by *firm personnel*, including an understanding of their roles and responsibilities with respect to the firm's QC system; and
- b. Enable an experienced auditor that understands QC systems, but has no experience with the design, implementation, and operation of the firm's QC system, to understand how the firm has designed, implemented, and operated the QC system to achieve the reasonable assurance objective, including the *quality objectives, quality risks, quality responses*, monitoring activities, remedial actions, and basis for the conclusions reached in the evaluation of the QC system.

.84 A complete and final set of documentation as required by paragraphs .81-.83 with respect to the 12-month period ending the prior November 30 and any evaluation required as of that date should be assembled for retention as of January 15 ("QC documentation completion date").

.85 Circumstances may require additions to documentation after the QC documentation completion date. Documentation must not be deleted or discarded after the QC documentation completion date; however, information may be added. Any documentation added must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it.

.86 The firm must retain documentation of its QC system for seven years from the QC documentation completion date, unless a longer period of time is required by law.

We believe that requiring documentation to be in sufficient detail to support a consistent understanding of the QC system by firm personnel, including an understanding of

their roles and responsibilities with respect to the firm's QC system, would help to clarify the firm's expectations of its personnel and promote consistent compliance with the firm's QC policies and procedures.

In the concept release, we stated that we were considering PCAOB-specific documentation requirements that would incorporate concepts from AS 1215. Specifically, we were considering requiring QC documentation to be sufficient to enable an experienced auditor that understands QC systems but has no experience with the design and implementation of the firm's QC system to understand the basis for the firm's assessment of the effectiveness of the QC system, including evaluation and remediation of QC deficiencies ("experienced auditor QC threshold"). Commenters had divergent views regarding this potential requirement. Some commenters, including firms, were supportive of introducing an experienced auditor QC threshold. Another firm and related groups were not supportive, arguing that the documentation requirements in proposed ISQM 1 would be sufficient.

One firm was concerned that the costs of an experienced auditor QC threshold could far outweigh the benefits, and could impede a firm's ability to properly scale the standard to the firm's facts and circumstances and adversely affect audit quality because firms may need to spend a disproportionate amount of time documenting their QC system rather than performing control activities. This commenter suggested that if we were to go beyond the documentation requirements in ISQM 1, we should align the requirements with those in Item 308 of Regulation S-K related to a company's documentation of its ICFR (i.e., documentation that provides "reasonable support").<sup>293</sup> The firm argued that this would be more appropriate because, in its view, the firm's documentation of the QC system is more like a company's documentation of its ICFR than the audit documentation subject to AS 1215. The firm also noted that one of the concerns that motivates the AS 1215 standard, changes in staff due to auditor rotation and staff turnover, would be less relevant in the context of the firm's QC system.

We are proposing that documentation of the QC system would have to meet the experienced auditor threshold. As described previously, documentation supports a firm's QC

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<sup>293</sup> Instruction 2 to Item 308 of Regulation S-K provides that public companies "must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the registrant's internal control over financial reporting." 17 C.F.R. § 229.308 (Instruction 2). In the SEC's interpretive release on management reporting on ICFR, the SEC clarifies that the nature of the evidential matter may vary based on the assessed level of ICFR risk of the underlying controls and other circumstances, and that, in determining the nature of supporting evidential matter, management should also consider the degree of complexity of the control, the level of judgment required to operate the control, and the risks of misstatement in the financial reporting element that could result in a material misstatement of the financial statements. *See Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*, SEC Securities Act Release No. 8810 (June 20, 2007), at 31-32.

system in a number of ways. For example, it provides clarity around the firm's policies and procedures, enables proper monitoring, and supports the evaluation and continuous improvement of a firm's QC system. Documentation also facilitates the retention of organizational knowledge, providing a history of the basis for decisions made by the firm about its QC system. Further, it assists others conducting reviews of the firm's QC system by providing evidence of the system's design, implementation, and operation. To effectively support the firm's QC system, the documentation should be at the level of detail that provides sufficient information about the design, implementation, and operation of the firm's QC system, including sufficient detail about the quality objectives, quality risks, quality responses, monitoring activities, remedial actions, and basis for the conclusions reached in the evaluation of the QC system. We believe that incorporating the experienced auditor concept when describing the extent of detail firms would be required to document and maintain regarding their QC system is appropriate because the level of detail could be helpful in the firm's monitoring activities and also in the Board's oversight activities.

The experienced auditor threshold contemplates an auditor who understands QC systems but does not necessarily have knowledge of or experience with the specific firm's QC system. We believe that an experienced auditor threshold, which is generally familiar due to its use in the auditing standards, could help firms understand the level of detail that is expected when documenting their QC system.

The proposed standard's approach to documentation requirements is principles-based and provides for scalability. When determining the form, content, and extent of documentation, the firm could consider, among other things, the nature and circumstances of the firm and the nature and complexity of the matter being documented. For example, for a large multi-office firm that performs many audits under PCAOB standards, the extent of documentation would be greater than for a small, single-office firm with a few firm personnel that audits one issuer or broker-dealer. The firm's documentation may take the form of formal written manuals and checklists or may be informally documented (e.g., in e-mail communications). The firm may determine that a detailed memo is a more appropriate form of documentation for more complex matters, whereas, for less complex matters, briefer communications, such as e-mail, may suffice. The nature and circumstances of the firm and the nature and complexity of the matter being documented are not the only factors that could drive the form, content, and extent of documentation. There may be other factors, such as the nature of the firm's engagements or the frequency and extent of changes in the firm's QC systems. We believe this principles-based approach provides for scalability.

The proposed standard would require the firm to assemble a complete and final set of documentation as of January 15 ("QC documentation completion date") with respect to the 12-month period ending the prior November 30 and any evaluation required as of that date.

The proposed standard permits additional documentation supporting a firm's QC system to be added after the QC documentation completion date in a manner similar to the addition of audit evidence to audit documentation under AS 1215.16. When this occurs, the proposed standard would require a firm to indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it. The proposed standard would also require all previously retained documentation supporting the firm's evaluation of its QC system to remain intact and not be discarded.

In the concept release, we also stated that we were considering requiring QC documentation to be retained for seven years, unless a longer period is required by law or regulation. Some commenters, including firms and a related group, agreed that a retention period of seven years would be appropriate. One of the firms suggested that the seven-year retention period should apply only to the specific documentation accumulated as part of the assessment of the QC system and not to all information contained in underlying firm systems that support the QC system. The firm pointed out that, for example, a firm's HR system, which could be considered to be part of a firm's QC system, would most likely contain sensitive and confidential information, such as personally identifiable information, and the retention period for this type of information may be governed by other laws. Some firms and related groups suggested aligning retention requirements with those of ISQM 1.<sup>294</sup> One firm stated that the document retention period should be determined by the firm. Other firms asserted that maintaining a version of the QC documentation for seven years would be burdensome because QC systems tend to be dynamic. Some firms suggested aligning documentation retention requirements with the firm's inspection and remediation cycle.

We question how the proposed retention period would be burdensome for firms since there is no obligation on the firm to take additional actions once the documentation is assembled for retention. We are also concerned that requiring the retention period to be aligned with the PCAOB inspection cycle would be too short. A firm's remediation activities may span multiple years and the actions taken by the firm in certain areas may be informed by prior actions. Further, the objective of the documentation requirement is much broader than providing evidence for inspection purposes or enabling proper remediation. As described earlier, the documentation may also be useful for training purposes, ensuring the retention of organizational knowledge, and providing a history of the basis for decisions made by the firm about its QC system.

The proposed standard would therefore require the firm to retain QC documentation for seven years from the QC documentation completion date, unless a longer period is required by law. This requirement would align the QC document retention requirement with other

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<sup>294</sup> ISQM 1 requires the firm to establish a retention period that is sufficient to enable the firm to monitor the design, implementation, and operation of the firm's system of quality management, or for a longer period if required by law or regulation. See paragraph 60 of ISQM 1.

requirements in PCAOB standards and SEC rules (such as Regulation S-X Rule 2-06). For consistency and practical application, the proposed retention period would be the same for all firms and would apply to all documentation the firm would be required to accumulate to meet the documentation requirements of the proposed standard. We are not proposing to identify specific types of documentation to be excluded, because the nature, timing, and extent of documentation would vary from firm to firm.

## 2. Current PCAOB standards

Existing QC 20 provides that:

- Appropriate consideration should be given to the extent to which QC policies and procedures, and compliance with them, should be documented.<sup>295</sup>
- The form, content, and extent of documentation depends on relevant factors, including the size, structure, and nature of the firm's practice.<sup>296</sup>
- A firm should prepare appropriate documentation to demonstrate compliance with its policies and procedures for the QC system.<sup>297</sup>
- Documentation should be retained for a period sufficient to enable those performing monitoring procedures and a peer review to evaluate the extent of the firm's compliance with its QC policies and procedures.<sup>298</sup>

QC 30 and the SECPS membership requirements include documentation requirements for certain items such as findings from certain monitoring activities, CPE, notification of cessation of client relationships, filing reviews under Appendix K, and corrective actions to address apparent independence violations.<sup>299</sup>

## 3. Key differences from other QC standards

The differences between our proposed documentation requirements and the provisions of other QC standards are:

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<sup>295</sup> See QC 20.21.

<sup>296</sup> See QC 20.24-.25.

<sup>297</sup> See QC 20.25.

<sup>298</sup> See QC 20.25.

<sup>299</sup> See, e.g., QC 30.08; SECPS §§ 1000.08(m), 1000.45, 1000.46, 8000.

- Incorporation of the experienced auditor concept when describing the extent of detail firms would be required to document and maintain regarding their QC system;
- Specifying a QC documentation completion date and a seven-year minimum documentation retention period;
- Allowing subsequent additions to the documentation supporting the firm's evaluation of its QC system after the QC documentation completion date; and
- Certain proposed documentation requirements go beyond the requirements in other QC standards because of differences in the underlying proposed requirements for the monitoring and remediation process.

## Questions

71. Are the proposed documentation requirements appropriate? If not, what changes should be made?
72. Is the "experienced auditor QC threshold" set out in the in the proposed documentation requirement appropriate? If not, what threshold is appropriate?
73. Are there additional specific matters that the firm should be required to document about its QC system? If so, what are they?

## V. ADDITIONAL PROPOSED AMENDMENTS

QC 1000 would supersede our existing interim QC standards in their entirety. Currently, Rule 3400T requires registered firms and their associated persons to comply with the AICPA's quality control standards as in existence on April 16, 2003, to the extent not superseded or amended by the Board. Rule 3400T identifies the AICPA's Statements on QC Standards (QC 20, QC 30, QC 40) and certain of the AICPA's SECPS membership requirements, which are applicable only to firms that were members of the AICPA SEC Practice Section on April 16, 2003. In connection with the proposal of a permanent QC standard, QC 1000, we are proposing to rescind Rule 3400T. In consequence, the interim quality control standards referenced in Rule 3400T would no longer be part of PCAOB standards. Rule 3400T is proposed to be replaced with Rule 3400, which would describe the auditor's responsibilities for complying with quality control standards adopted by the Board and approved by the SEC.

The other amendments to PCAOB standards, rules, and forms that we are proposing are described below.

## A. Proposed Amendments to AS 2901, *Consideration of Omitted Procedures After the Report Date*, and Related Proposed Amendments

### 1. Background

Currently, AS 2901 applies when the auditor concludes, after issuing its report on the financial statements, that procedures “considered necessary at the time of the audit in the circumstances then existing” were omitted from an audit of the financial statements, but there is no indication that the financial statements are not fairly presented.<sup>300</sup> It requires remedial action (i) if the auditor concludes that the omitted procedures impair its ability to support the previously issued opinion, and (ii) people are likely to rely on the report. If remedial action is required but the auditor is not able to perform the omitted procedures or alternative procedures that support the opinion, the standard directs the auditor to consult with counsel. AS 2901 does not apply to ICFR audits or to attestation engagements.

The concept release discussed updating and clarifying certain aspects of AS 2901. Specifically, the concept release described explicitly requiring auditors to evaluate information coming to their attention that indicates the opinion in a previously issued audit report might not have been supported by sufficient appropriate evidence and, when such circumstances exist, applying procedures to obtain the necessary evidence. The concept release asked whether these potential amendments were appropriate. Some commenters supported the potential amendments or were in favor of providing greater clarity to existing requirements in AS 2901. Other commenters said that the existing requirements were clear and no changes were necessary. One commenter suggested the Board have a separate project to clarify the requirements of AS 2901.

### 2. Proposed amendments to AS 2901

We believe amendments to AS 2901 may be appropriate to modernize the standard, incorporating the concepts and terminology introduced in proposed QC 1000 and bringing the standard into alignment with the auditor’s existing responsibility to obtain sufficient appropriate audit evidence to support the opinion. The proposed amendments to AS 2901 are set forth in Appendix 3.

Proposed QC 1000 introduces a new term, “engagement deficiency,” defined as an instance of noncompliance with applicable professional or legal requirements by the firm, firm personnel, or other participants with respect to an engagement of the firm, or by the firm or

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<sup>300</sup> AS 2905, rather than AS 2901, applies if the auditor subsequently learns of facts regarding the financial statements existing at the date of its report that might have affected its opinion. Paragraph .98 of AS 2201 is an analogous provision in the context of ICFR audits.

firm personnel with respect to an engagement of another firm. For an engagement deficiency related to a completed engagement, proposed QC 1000 would require firms to take action to address the engagement deficiency “in accordance with applicable professional and legal requirements” (i.e., AS 2901, AS 2905, AS 2201.98).

We are proposing to broaden the scope of AS 2901 and to incorporate this new terminology, so that remedial action would be required for engagement deficiencies for both financial statement audits and ICFR audits unless it was probable that the engagement report was not being relied upon.<sup>301</sup> Reflecting this broader scope, we also propose to change the name of the standard to “Responding to Engagement Deficiencies After Issuance of the Auditor’s Report.”

#### a. Scope and applicability

##### Introduction

.01 This standard applies when, after issuance of an auditor’s report, an engagement deficiency is identified on an audit of financial statements or internal control over financial reporting, unless it is probable that the auditor’s report is not being relied upon.

Note 1: The firm must treat as relied upon any auditor’s report that is included in the most recent filing on an SEC form that requires inclusion of such an auditor’s report.

Note 2: AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report*, and paragraph .98 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, may also apply in these circumstances.

##### Objective

.02 The objective of the auditor is to take appropriate action to respond to identified engagement deficiencies.

Note that, under PCAOB Rule 1001(a)(xii), “auditor” as used in AS 2901 means both firms and their associated persons.

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<sup>301</sup> See QC 1000.68b.

### i. Engagements covered

Current AS 2901 predates ICFR audit requirements and applies only to financial statement audits. We are proposing to extend the scope of AS 2901 to cover engagement deficiencies in ICFR audits as well. Similar to the concept in existing AS 2901, we would exclude engagements where it is probable that the audit report is not being relied upon.<sup>302</sup>

The determination that an audit report is not being relied upon would be influenced by several factors, which the auditor would need to consider when determining whether AS 2901 applies. Circumstances that may suggest the auditor's report is no longer being relied upon could include:

- So much time has elapsed that the financial statements covered by the auditor's report are no longer required to be included in SEC periodic reports.
- The issuer's or broker-dealer's business has been dissolved.

The proposed standard includes a note that clarifies the firm must treat an audit report as being relied upon if the audit report is included in the most recent SEC filing on a form that requires its inclusion.

### ii. Compliance with AS 2905/AS 2201.98

Under the proposed amendment, AS 2901 would point the auditor to AS 2905 or AS 2201.98 to the extent they apply. This would preserve the difference in treatment that exists under current auditing standards between situations where financial statements and potentially the audit opinion may be in doubt (AS 2905 or AS 2201), and other circumstances where remedial action is required but there is no initial indication that the financial statements might be misstated (AS 2901).

### iii. Deficiencies covered

AS 2901 currently applies only when the auditor concludes that procedures considered necessary at the time of the audit in the circumstances then existing were omitted. We propose to extend AS 2901 to cover all engagement deficiencies identified. We believe that it would be more consistent with the basic philosophy of proposed QC 1000, and would better support the

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<sup>302</sup> Under current AS 2901, the test is whether the auditor believes there are persons currently relying, or likely to rely, on the audit report. Under the proposal, the test would be whether it is probable that no one is relying, without reference to the auditor's belief. The term "probable" has the same meaning as described in the FASB ASC paragraph 450-20-25-1.

ultimate goal of improving audit quality, to require remedial action for all engagement deficiencies, regardless of whether the audit opinion is unsupported.

#### **b. Remediation activities**

AS 2901 currently requires remedial action only when, due to omitted procedures that were considered necessary at the time of the audit, the auditor's opinion is not sufficiently supported. The required action is to perform the omitted procedures or alternative procedures that would support the opinion. If that is not possible, the auditor is directed to consult an attorney to determine an appropriate course of action.

The proposed amended standard would require remedial action for all engagement deficiencies—both those engagement deficiencies that affect the auditor's opinion and those that do not—on audits of both financial statements and ICFR.

#### **i. Addressing engagement deficiencies related to an unsupported auditor's opinion**

##### **Responding to the Engagement Deficiency**

.03 For engagement deficiencies where the auditor did not obtain sufficient appropriate audit evidence to support the auditor's opinion, the auditor should:

- a. Perform procedures to obtain additional evidence, to the extent necessary, such that the opinion is supported by sufficient appropriate evidence; or
- b. Take action to prevent future reliance on the report in the manner specified in paragraphs .06-.09 of AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

For engagement deficiencies where the auditor determines sufficient appropriate audit evidence to support the auditor's opinion was not obtained, the auditor would either:

- Perform procedures to obtain additional evidence such that the opinion is supported by sufficient appropriate evidence, or
- Take action to prevent future reliance on the report in the manner specified in AS 2905.06-.09.

The type of procedures that the auditor performs in response should be guided by the type and amount of evidence needed to support the auditor's opinion. If the auditor determines it is not able to obtain sufficient appropriate evidence to support its previously

issued opinion, the auditor would be required to take appropriate action to prevent future reliance on the audit report. We propose to amend AS 2201 to include a reference to AS 2901 (as proposed to be amended) as a reminder of auditor responsibilities under that section with respect to audits of internal control over financial reporting.<sup>303</sup>

## ii. Addressing all other engagement deficiencies

.04 For other engagement deficiencies, the auditor should take action to address the deficiency, taking into account the nature and severity of the deficiency.

Note: Remedial actions a firm may take include: (1) corrective actions to address engagement deficiencies on completed engagements; and (2) preventive actions to deter future engagement deficiencies.

For all other deficiencies on audit engagements, we propose that the auditor would perform remedial actions, similar to those described in QC 1000.69, based on the auditor's determination of what action (corrective, preventive, or both) is appropriate based upon the specific facts and circumstances. Consider the following different potential responses to engagement deficiencies:

- Take corrective action to completely remediate the deficiency, where appropriate.
- For deficiencies that cannot be completely remediated, remediate to the extent possible and implement measures to prevent recurrence. For example, if a Form AP was filed late, the auditor would not be able to remediate the lateness but could improve the controls over the filing process.
- The firm might determine based on the facts and circumstances that no further remedial action is necessary, e.g., because of remedial actions already taken to respond to other deficiencies.

## c. Documentation

### Documentation

.05 The auditor should comply with:

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<sup>303</sup> See Appendix 5, Other Proposed Amendments.

- a. Paragraph .16 of AS 1215, *Audit Documentation*, when documenting its response to engagement deficiencies within the working papers; and
- b. QC 1000.82c. when documenting the actions taken to address engagement deficiencies as part of the monitoring and remediation process of its QC system.

When the auditor's response to engagement deficiencies involves adding additional information to the auditor's working papers, the requirements of AS 1215.16 would apply.

Under the proposed amendments, the auditor would document the actions taken pursuant to paragraphs .03 and .04 to address engagement deficiencies in an audit engagement where the audit report has previously been issued. This documentation requirement is consistent with the documentation requirements in proposed QC 1000.82c. for all engagement deficiencies.

### 3. Related proposed amendments

In the concept release, we discussed adding provisions similar to AS 2901 to the standards for broker-dealer attestation engagements, AT No. 1 and AT No. 2, to prompt auditors of brokers and dealers to take appropriate action if they discover that the opinion or conclusion in a previously issued attestation report was not supported. Currently, those standards are silent as to the responsibilities that apply when a deficiency is identified after the engagement report is issued.<sup>304</sup> We are proposing amendments to these standards that mirror our proposed amendments to AS 2901. The text of the proposed amendments to AT No. 1 and AT No. 2 appears in Appendix 5.

At this time, we are not proposing to amend our interim attestation standards to include provisions similar to AS 2901. The Board's current standard-setting agenda includes a short-term project to evaluate the interim attestation standards. In connection with that project, PCAOB staff is obtaining and analyzing information to develop potential recommendations to amend, consolidate or eliminate certain attestation standards.<sup>305</sup> In the future, the Board may consider changes to practitioners' responsibility to respond to engagement deficiencies as part of that project.

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<sup>304</sup> By comparison, paragraph .99 of AT 101 provides that the practitioner "may wish to consider the guidance in AS 2905" in such a circumstance.

<sup>305</sup> See Request for Information and Comment, *The Application and Use of the PCAOB's Interim Attestation Standards* (Sept. 26, 2022).

## Questions

74. Is the proposal to expand the scope of AS 2901 to include engagement deficiencies on ICFR audits appropriate? If not, why not?

75. Is it appropriate for remedial action to be required for all identified engagement deficiencies, not just in situations where the auditor's opinion may be unsupported? If not, why not?

### B. Proposed rescission of ET Section 102; proposed new standard EI 1000; proposed amendments to ET Section 191

We are proposing to rescind an interim ethics and independence standard, ET 102, *Integrity and Objectivity*, and replace it with a new standard, EI 1000, *Integrity and Objectivity*. Proposed EI 1000 is based on existing ET 102, including its related interpretations codified as ET 102.02, .03, and .05, but reflects revisions that we believe would better align our ethics requirements with the scope, approach, and terminology of proposed QC 1000. To take one example, the new EI 1000 would apply to registered public accounting firms and their associated persons rather than current AICPA "members" as referenced in ET 102.

As a threshold matter, we are proposing to use a new designation, "EI," for our ethics and independence standards. We are not proposing to rename our remaining interim ethics and independence standards at this time, but we anticipate that any rulemaking that may emerge from the current standard-setting project addressing our ethics and independence standards would use that new designation.

.01 In connection with their responsibilities under applicable professional and legal requirements and the firm's policies and procedures related thereto (for example, training activities and other professional development; engagement planning, performance, and supervision; and communication with clients, other firm personnel, and regulators), a registered public accounting firm ("firm") and its associated persons must maintain integrity and objectivity.

.02 Integrity includes:

- a. Being honest and candid.
- b. Not knowingly or recklessly misrepresenting facts. Misrepresenting facts includes knowingly or recklessly making, or permitting or directing another to make, materially false or misleading statements, including knowingly or recklessly (1) signing, or permitting or directing another to sign, a document containing materially false or misleading information and (2) failing to correct a document that is materially false and misleading when having the authority to do so.

c. Not subordinating professional judgment. If a person associated with a registered firm and such person's supervisor have a disagreement or dispute over applicable professional and legal requirements or how to apply or comply with them, the associated person should take the following steps to ensure that the situation does not constitute a subordination of judgment:

- (1) Consider whether the supervisor's approach results in a violation of applicable professional and legal requirements.
- (2) If, after appropriate research or consultation, the associated person concludes that the supervisor's approach has sufficient support under applicable professional and legal requirements or does not constitute such a violation, the person need do nothing further.
- (3) If, after appropriate research or consultation, the associated person concludes that there is insufficient support under applicable professional and legal requirements and the supervisor's approach could constitute a violation of applicable professional and legal requirements, the associated person should make their concerns known to the appropriate higher level(s) of management (for example, the supervisor's immediate superior or senior management). The associated person should also consider documenting their understanding of the facts, the applicable professional and legal requirements involved, the application of those requirements to the facts, and the parties involved in any relevant consultation or discussion.
- (4) If appropriate action is not taken, the associated person should consider:
  - (a) Potential responsibilities to notify third parties (e.g., regulatory authorities, audit committees); and
  - (b) The appropriateness of maintaining a continuing relationship with the firm.

.03 Objectivity includes:

- a. Being impartial.
- b. Being intellectually honest.
- c. Being free of conflicts of interest. A conflict of interest arises if a firm or any of its associated persons has a relationship with another person, entity, or service that may reasonably be thought to bear on the ability of the firm or the associated person to exercise objective and impartial judgment in connection with their

responsibilities under applicable professional and legal requirements with respect to an engagement not involving such other person, entity, or service.

- (1) In general, if the firm believes that the firm and its associated persons can perform their respective responsibilities under applicable professional and legal requirements with objectivity, and the relationship is disclosed to and approval is obtained from the audit committee, this standard does not prohibit the performance of the engagement.
- (2) Independence violations, as determined under applicable professional and legal requirements, cannot be eliminated by such disclosure and approval.

Integrity and objectivity are foundational to the audit and critical to the performance of engagements under PCAOB standards. They lend credibility and engender trust in financial reporting. As the U.S. Supreme Court pointed out in *United States v. Arthur Young*:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times, and requires complete fidelity to the public trust.<sup>306</sup>

The responsibility to maintain integrity and objectivity is an important counterbalance to the risk that the auditor may be unduly influenced by company management or may be subject to cognitive or other biases in performing the audit.<sup>307</sup> In turn, an auditor's integrity and objectivity can help to increase investor trust in financial reporting and strengthen capital markets.

Currently, paragraph .01 of ET 102 sets out three requirements that apply in the performance of a professional service: (i) maintaining integrity and objectivity, (ii) being free of conflicts of interest, and (iii) not knowingly misrepresenting facts or subordinating judgment. The remaining paragraphs of the rule and the relevant portions of ET 191 provide more detailed direction in specific contexts.

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<sup>306</sup> *United States v. Arthur Young*, 465 U.S. 805, 818 (1984).

<sup>307</sup> See, e.g., *Auditing Accounting Estimates, Including Fair Value Measurements and Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2018-005 (Dec. 20, 2018), at pp. 30-35 (discussing auditor incentives and potential cognitive biases).

We are proposing to create two overarching requirements in EI 1000: (i) maintaining integrity, which would include being honest and candid, not knowingly or recklessly misrepresenting facts, and not subordinating judgment; and (ii) maintaining objectivity, which would include being impartial, intellectually honest, and free of conflicts of interest. These proposed requirements are substantially based on existing requirements.

The proposal would recodify in EI 1000 the descriptions of integrity and objectivity that currently appear in QC 20.10, given that QC 20 is proposed to be rescinded.<sup>308</sup> Proposed EI 1000.02 notes that, as part of maintaining impartiality, a firm and its associated persons must be “honest and candid.” This requirement is drawn from existing QC 20.10. We propose to omit the reference to “within the constraints of client confidentiality” in order to avoid suggesting that “client confidentiality” could limit a firm’s or its associated persons’ obligations to comply with the requirements of PCAOB rules or standards. This is consistent with the Board’s current interpretation of QC 20.10, under which a firm or its associated persons must be honest and candid in complying with PCAOB rules and standards, including during PCAOB inspections. It also confirms, among other things, that associated persons have the ability to report wrongdoing within the firm and to the appropriate regulatory authorities without constraints of confidentiality, consistent with PCAOB rules and standards.

Similar to current QC 20.10, proposed EI 1000.02 would not address the requirements of client confidentiality beyond the requirements set forth in PCAOB rules and standards and applicable requirements of the federal securities laws, including the Sarbanes-Oxley Act.<sup>309</sup>

In addition to substantially recodifying existing requirements, we are also proposing to make a number of changes to broaden and clarify the scope of the rule and more closely align it with the scope, approach, and terminology of proposed QC 1000, including:

- Clarifying that the requirements of proposed EI 1000 would apply in connection with all responsibilities under “applicable professional and legal requirements” (as defined in proposed QC 1000) and the firm’s related policies and procedures, whether in relation to the firm’s engagements, work the firm does on other firms’

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<sup>308</sup> QC 20.10 states “Integrity requires personnel to be honest and candid within the constraints of client confidentiality.... The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.”

<sup>309</sup> As a general matter, the Uniform Accountancy Act excludes from the prohibition against voluntary disclosure, in part, “information required to be disclosed by the standards of the public accounting profession in reporting on the examination of financial statements or as prohibiting compliance with *applicable laws, government regulations or PCAOB requirements . . .*,” available at <https://us.aicpa.org/content/dam/aicpa/advocacy/state/downloadabledocuments/uaa-eighth-edition-january-2018.pdf> (emphasis added).

engagements, training, independence monitoring, or other activities that are part of or subject to the firm's QC system;

- Clarifying that the responsibility to avoid factual misrepresentations covers not only knowing, but also reckless behavior, and that this responsibility applies to any knowing or reckless misrepresentation of fact, including situations where documents—such as work papers and communications with the PCAOB and the SEC—containing materially false or misleading information are knowingly or recklessly signed, permitted or directed to be signed, or left uncorrected by those with authority to correct them; and
- Broadening the responsibility to avoid subordination of judgment so it would apply to any dispute or disagreement over applicable professional and legal requirements or how to apply them.

The proposal would also modernize the standard and align it with our other standards and rules by renumbering it in accordance with our reorganized standards framework, including our proposed new "EI" designation for ethics and independence standards; incorporating PCAOB terminology; and eliminating outdated provisions. Proposed EI 1000 would apply to registered firms and their associated persons, rather than to "members" as ET 102 currently provides, and would use certain terms, like "applicable professional and legal requirements," that would be defined in other PCAOB standards.

Given the prevalence of the terms "impartial" and "intellectually honest" in various auditing standards, including PCAOB standards, we preliminarily believe that no additional guidance would be necessary with regard to these terms. However, we are soliciting comment on whether additional terms should be defined or further guidance should be provided.

Additionally, we propose to rescind the former AICPA interpretations currently codified as ET 102.04, .06, and .07, which address members' obligations to their employer's external accountant, performance of educational services, and professional services involving client advocacy, respectively. Our preliminary view is that they are generally not relevant to engagements performed under PCAOB standards, and in addition, that the matters addressed in paragraph .07 are either effectively superseded by Regulation S-X Rule 2-01 or more effectively addressed elsewhere in our standards (e.g., AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors*).

In connection with proposing EI 1000, we are also proposing a number of amendments to ET 191, including a conforming amendment to paragraph .062 and rescinding paragraphs .130, .131, .170, .171, .186, .187, .198, .199, .202, and .203. Our preliminary view is that the interpretations proposed to be rescinded (addressing, respectively, use of the CPA designation by accountants not in public practice, service as a director of a bank, service on the board of directors of United Way or a similar federated fund-raising organization, providing services for

company executives, and providing client advocacy services) are generally not relevant to engagements performed under PCAOB standards or are addressed elsewhere in PCAOB and SEC rules. We are not proposing to amend the portions of ET 191 that pertain to ET 101, which is not the subject of this rulemaking. See Appendix 4 for the proposed rule text.

## Questions

76. Is the proposal to rescind ET 102 and replace it with EI 1000 appropriate in light of the changes proposed in QC 1000 and developments since 2003? If not, why not?

77. Are the terms used in EI 1000 clear? Should additional terms be defined or additional guidance provided?

78. Is the proposal to amend ET 191, including the proposed rescission of certain paragraphs, appropriate? Should any of the proposed interpretations be retained in our standards?

## C. Other Proposed Amendments

In connection with the proposal of QC 1000, the Board is also proposing amendments to other professional standards, PCAOB rules, and PCAOB forms. As discussed in more detail below, these proposed amendments would:

- Align terminology, concepts, and cross-references with proposed QC 1000;
- Rescind standards that would become unnecessary if proposed QC 1000 were adopted;
- Recodify certain provisions of requirements that are proposed to be rescinded into other PCAOB standards and rules; and
- Make other technical and clarifying amendments.

These proposed amendments are discussed further below. The proposed text of the amendments appears in Appendix 5.

### **1. Proposed rescission of Rule 3400T, *Interim Quality Control Standards*; Proposed Rule 3400, *Quality Control Standards***

PCAOB Rule 3400T, *Interim Quality Control Standards*, requires registered public accounting firms and their associated persons to comply with the Board's interim quality control standards. We are proposing to rescind Rule 3400T, including all current QC standards

identified in the rule, which the Board adopted on an interim, transitional basis.<sup>310</sup> The complete list of QC standards is included in Appendix 5. The auditor's responsibilities for complying with the Board's quality control standards would appear in a new permanent rule, Rule 3400.

## **2. Proposed amendments to Rule 3500T, *Interim Ethics and Independence Standards***

We are proposing to amend paragraph (a) of Rule 3500T to eliminate the introductory phrase "In connection with the preparation or issuance of any audit report," which we believe may cause the rule to be read unduly narrowly. We also propose to eliminate references to ET Section 102, *Integrity and Objectivity*, and substitute a reference to EI 1000, *Integrity and Objectivity*.

## **3. Proposed amendments to AS 1010, *Training and Proficiency of the Independent Auditor***

The proposed amendments to AS 1010 are comprehensive. They would align the standard with the approach and terminology of proposed QC 1000<sup>311</sup> and would add cross-references to other relevant PCAOB standards. The proposed amendments would address assigning to an audit engagement an auditor who has the competence to conduct an audit in accordance with applicable professional and legal requirements and the responsibility of the auditor to develop and maintain competence. This includes replacing the concept of "technical training and proficiency" with "competence."

## **4. Proposed rescission of AS 1110, *Relationship of Auditing Standards to Quality Control Standards***

At the time AS 1110 was issued, it served to describe the relationship between the then already-existing auditing standards and the new set of standards that governed a firm's system of quality control. This relationship is now well understood by firms and clarified within the proposed QC standard. In addition, the first two paragraphs of AS 1110 merely repeat the

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<sup>310</sup> Under PCAOB Rule 3400T(a), all firms are required to comply with QC standards as described in "the AICPA's Auditing Standards Board's Statements on Quality Control Standards, as in existence on April 16, 2003 (AICPA Professional Standards, QC §§ 20-40 (AICPA 2002)), to the extent not superseded or amended by the Board." PCAOB Rule 3400T(a). PCAOB Rule 3400T(b) requires certain firms to comply with QC standards as described in "the AICPA SEC Practice Section's Requirements of Membership (d), (l), (m), (n)(1) and (o), as in existence on April 16, 2003 (AICPA SEC Practice Section Manual § 1000.08(d), (j), (m), (n)(1) and (o)), to the extent not superseded or amended by the Board." PCAOB Rule 3400T(b). Rule 3400T provides that those requirements "only apply to those registered public accounting firms that were members of the AICPA SEC Practice Section on April 16, 2003." Note to PCAOB Rule 3400T.

<sup>311</sup> See QC 1000.44a.-e.

requirements to comply with the auditing and QC standards that are addressed by other PCAOB standards and rules. Accordingly, we propose to rescind AS 1110.

The concept release requested input on whether the standard provided helpful direction to auditors, or if it should be rescinded. Several commenters supported rescinding AS 1110, largely on the basis that it is unnecessary. However, several other commenters, including firms and related groups, expressed support for keeping AS 1110. Many of these commenters pointed to the concepts in AS 1110.03, specifically the language in the last sentence that states “deficiencies in or instances of noncompliance with a firm’s quality control policies and procedures do not, in and of themselves, indicate that a particular audit engagement was not performed in accordance with the auditing standards.” Some of these commenters expressed concern that removing this language would effectively imply that we no longer agree with this concept. Another commenter suggested enhancing AS 1110 to align it with the IAASB’s ISA 220 (Revised), *Quality Management for an Audit of Financial Statements*.

Proposed QC 1000 addresses these commenters’ concerns in a different way. Proposed QC 1000 clearly articulates the difference between a QC deficiency and an engagement deficiency, so that there would be no basis to infer that a QC deficiency necessarily implies an engagement deficiency. Accordingly, we are not proposing to retain the disclaimer in AS 1110.

## **5. Proposed amendments to AS 1301, *Communications with Audit Committees***

The proposed amendments to AS 1301 would require firms to report to audit committees about the most recent annual evaluation of their QC system and a brief overview of remedial actions for any QC deficiencies that were unremediated at the time of the firm’s evaluation. We have tailored the proposed auditor communication requirement to avoid compelling a firm to disclose nonpublic inspection information to an audit committee.<sup>312</sup>

The proposed auditor communication requirement could enhance audit committee oversight by providing potentially valuable information about the firm and greater context and insight into the audit process. We believe that such information could be relevant to the audit committee’s responsibilities in connection with auditor appointment and retention. We also note that firms performing audits of New York Stock Exchange-listed companies already communicate information about their quality control to their client’s audit committees under

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<sup>312</sup> Sarbanes-Oxley restricts what the Board may publicly disclose about the results of PCAOB inspections and any necessary remediations by the firm. See Section 104(g)(2) of Sarbanes-Oxley, 15 U.S.C. § 7214(g)(2). Sarbanes-Oxley does not restrict a firm from making disclosures to an audit committee about inspection matters, and the Board encourages firms to communicate effectively with audit committees about such matters. See *Information for Audit Committees About the PCAOB Inspection Process*, PCAOB Release No. 2012-003 (Aug. 1, 2012), at 9-10.

applicable listing requirements.<sup>313</sup> We believe that extending a similar requirement to all firms could promote beneficial dialogue between the auditor and the audit committee about QC matters.

#### **6. Proposed new standard AS 1310, *Notification of Termination of the Auditor-Client Relationship***

A proposed new standard, AS 1310, would recodify existing requirements of SECPS § 1000.08(m), *Notification of the Commission of Resignations and Dismissals from Audit Engagements for Commission Registrants*, and apply those requirements to all firms and all issuer engagements. As noted above, we are proposing to rescind the QC standards that pertain only to firms that were SECPS members at the time the PCAOB was created. In lieu of the SECPS requirement, we are proposing to codify in a new standard the requirement to notify the SEC upon resignation or dismissal from an audit engagement of an issuer if the issuer does not report such change in a current report on Form 8-K. This requirement would apply to all issuer engagements, regardless of whether the firm was a member of the SECPS and regardless of whether the issuer is required to report on Form 8-K. We believe such notice could provide valuable information to the SEC.

#### **7. Proposed amendments to AT Section 101, *Attest Engagements***

The proposed amendments to AT Section 101 would align with the proposed rescission of AS 1110 discussed above, by deleting the paragraphs that address the relationship of attestation standards to QC standards. Additionally, the proposed deletion of footnote 23 would remove language related to monitoring compliance with quality control policies and procedures, which would become unnecessary if QC 1000 is adopted.

#### **8. Proposed amendments to Form 1, *Application for Registration***

We are proposing to amend Form 1 to (i) refer to QC 1000 in the instructions in order to prompt firms to consider their obligations with respect to QC in connection with their application for registration, and (ii) add a new item whereby firms would confirm whether they have designed a QC system in accordance with PCAOB standards.

#### **9. Proposed amendments to Form 2, *Annual Report Form***

We are proposing to amend Form 2 to add a new item whereby firms would confirm (i) that they have designed a QC system in accordance with PCAOB standards; and (ii) whether they were required to implement and operate a QC system in accordance with PCAOB standards at any time during the period of time covered by Form 2.

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<sup>313</sup> See *NYSE Listed Company Manual*, Section 303A.07(b)(iii)(A).

## 10. Technical and conforming amendments

We are proposing a number of technical and conforming amendments to align terminology and concepts in existing standards and one PCAOB form with proposed QC 1000 and EI 1000.

We are also proposing a technical amendment to the instructions to Form AP to clarify an exclusion from disclosing the identity of, and hours incurred by, accounting firms in certain circumstances. The Board, when it adopted Form AP, stated that it intended to exclude the reporting of “hours incurred in the audit of entities in which the issuer has . . . an investment” using the equity method of accounting.<sup>314</sup> Form AP currently excludes hours “of an accounting firm performing the audit of entities in which the issuer has an investment that is accounted for using the equity method,” but we are concerned that such language might be read to exclude all of the audit work performed by such an accounting firm on an audit, rather than only those hours spent performing the audit of entities in which the issuer has an investment accounted for using the equity method. We propose to revise the instruction in Part IV of the form to exclude from its disclosure requirements the identity of, and hours incurred by, accounting firms “in performing” the audit of entities in which the issuer has an investment that is accounted for using the equity method, which is intended to clarify that the identity of, and hours incurred by, such firms with respect to other work on the audit must be disclosed on Form AP, unless they are subject to other Form AP exclusions.

### Questions

79. Are the proposed amendments to other PCAOB standards and rules appropriate? If not, why not? Are there additional amendments to other PCAOB standards or rules that the Board should consider?

80. Are the proposed amendments to Form 1 and Form 2 in Appendix 5 appropriate? If not, why not?

## VI. ECONOMIC ANALYSIS

Economic analysis is an important aspect of the rulemaking process. This economic analysis describes the baseline for evaluating the potential economic impacts of the proposed rulemaking, the need for rulemaking, its potential economic impacts (including benefits, costs, and unintended consequences), and reasonable alternatives considered. Due to data limitations, much of the economic analysis is qualitative in nature; however, where reasonable

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<sup>314</sup> 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), at 26.

and feasible, the analysis incorporates quantitative information, including information from PCAOB inspections of registered firms.

## A. Baseline

Section II provides an overview of current PCAOB QC standards; summarizes observations from PCAOB oversight activities; and describes developments in the auditing environment since the adoption of current PCAOB QC standards, including the actions of other standard setters. This section expands on that discussion by describing additional aspects of the economic baseline against which the potential impact of the proposed requirements can be considered and presenting other relevant information on the audit services market for issuers and broker-dealers. Specifically:

- Section VI.A.1 presents the time trends of three complementary proxies for the level of compliance with professional standards applicable to the performance of engagements, derived from PCAOB inspections data. Analysis of these proxies informs the baseline for considering the potential benefit of the proposed requirements (e.g., improved compliance with professional standards).<sup>315</sup>
- Section VI.A.2 presents information on resources that U.S. global network firms (“GNFs”) invest in their QC systems. As the proposed requirements would result in changes to some firms’ QC systems, this information informs the baseline for considering the potential costs of the proposed requirements.
- Section VI.A.3 describes changes firms have made to their QC systems to remediate QC deficiencies identified by inspections staff and presents the time trend of QC deficiencies related to firms’ management of their audit practices. This discussion provides information on the evolution of QC systems and informs our evaluation of the need for and the potential impacts of the proposed requirements.
- Section VI.A.4 provides a concise survey of academic literature on quality-threatening behaviors that suggest certain weaknesses in some QC systems in practice.
- Section VI.A.5 discusses key assumptions regarding how QC systems are likely to evolve absent the proposed requirements.

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<sup>315</sup> See Section VI.C.1.b for further discussion.

In describing the baseline,<sup>316</sup> the analysis presents anonymized and aggregated summary statistics regarding deficiencies included in past PCAOB inspection reports. Since PCAOB inspection reports do not consider broker-dealer engagements, the analysis also presents anonymized and aggregated summary statistics regarding audit and attestation engagement deficiencies included in annual reports on the PCAOB's interim inspection program related to audits of brokers and dealers. The following background information associated with this quantitative inspection information bears emphasizing:

1. QC deficiencies presented in Part II of a PCAOB inspection report<sup>317</sup> may relate to (1) a firm's management of its audit practice or (2) a firm's performance of audit procedures.<sup>318</sup> QC deficiencies of the first type refer to the operation of QC policies and procedures. For example, a QC deficiency related to a firm's management of its audit practice may be identified through inspection staff's review of how the firm considers and addresses risks in connection with client acceptance and continuance decisions. QC deficiencies of the second type are inferred through analysis of deficiencies identified during inspections of individual issuer audit engagements. For example, a QC deficiency related to a firm's performance of audit procedures may be identified through inspection staff review of the performance of audit procedures related to management's accounting estimates.<sup>319</sup>
2. Deficiencies presented in Part I.A of an inspection report represent deficiencies in issuer audits selected for inspection that were of such significance that the Board believes that the firm, at the time it issued its audit report, had not obtained

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<sup>316</sup> The scope of the information on inspections and remediation efforts presented in the baseline section is limited to those firms that are subject to inspection under Sarbanes-Oxley; specifically, firms that provide one or more audit reports for an issuer, broker, or dealer. See Section 104(a)(1), (2) and (b)(1) of Sarbanes-Oxley, 15 U.S.C. §§ 7214(a)(1), (2) and (b)(1). In particular, our analysis of deficiencies included in past PCAOB inspection reports does not include registered firms that would be subject only to design requirements on the basis that they do not perform "engagements" as defined in QC 1000. Based on Form 2 reporting as of March 31, 2022, approximately 59% of registered firms reported that they had not issued an audit report for an audit of an issuer or broker-dealer or played a substantial role in such an engagement during the preceding 12 months.

<sup>317</sup> Part II of a firm's inspection report may include criticisms of, and potential defects in, the firm's QC system. As required under the Sarbanes-Oxley Act, any QC deficiencies observed during a PCAOB inspection are not included in the public portion of the relevant inspection report when first issued. If a firm does not address to the Board's satisfaction criticisms of, and potential defects in, the firm's QC system within 12 months after the issuance of the PCAOB inspection report, Part II of the report will be issued publicly to include such deficiencies. Additional information is available on the PCAOB website at <https://pcaobus.org/oversight/inspections/remediation>.

<sup>318</sup> See PCAOB Release No. 2012-003, at 8-9.

<sup>319</sup> See PCAOB Release No. 2012-003, at 8.

- sufficient appropriate audit evidence to support its opinion on the issuer's financial statements and/or internal control over financial reporting. As part of the PCAOB's process for reviewing firms' QC systems, PCAOB inspection teams evaluate whether identified deficiencies in individual audits indicate a defect or potential defect in a firm's QC system. However, a Part I.A deficiency does not, on its own, necessarily imply significant defects or potential defects in a firm's QC system. The PCAOB inspection team will consider the nature, significance, and frequency of deficiencies and related firm methodology, guidance, practices, and possible root causes when assessing whether Part I.A deficiencies in individual audits indicate sufficiently significant defects or potential defects in a firm's QC system that should appear in Part II of the firm's inspection report.<sup>320</sup>
3. The Dodd-Frank Wall Street Reform and Consumer Protection Act gave the PCAOB oversight of auditors of broker-dealers registered with the SEC. In June 2011, the PCAOB established an interim program to inspect these auditors and identify and address with them any significant issues observed in their audits and related attestation engagements. This interim inspection program remains in place today. The inspection processes for audits of issuers and broker-dealers are different in many respects including the applicable laws, rules, and professional standards; the inspection selection process; inspection focus areas; and reporting of inspection results. In particular, unlike PCAOB inspections of issuer audits, which lead to an inspection report for each inspected firm, the PCAOB issues a single annual report on the interim inspection program related to audits of brokers-dealers, which summarizes the results of the PCAOB's inspections of broker-dealer engagements performed during the previous year.<sup>321</sup>
  4. Our analysis of QC and issuer audit deficiencies below is presented over a ten-year period for three separate categories of firms: (1) U.S. GNFs, (2) firms having more than five inspected issuer engagements, and (3) firms having five or fewer inspected issuer engagements.<sup>322</sup> Categorizing inspections information among firms of

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<sup>320</sup> Additional information on PCAOB inspection procedures is available on the PCAOB website at <https://pcaobus.org/oversight/inspections/inspection-procedures>.

<sup>321</sup> See 2021 Broker-Dealer Inspection Report. Additional information on the interim inspection program is available on the PCAOB website at <https://pcaobus.org/resources/information-for-audit-firms/information-for-auditors-of-broker-dealer>.

<sup>322</sup> Time trends can help to identify associative relationships and may suggest how the audit market could evolve absent the proposed requirements. However, time trends in PCAOB inspection deficiencies depend on, among other things, changes in the set of firms and engagements selected for inspection. Firms that issue 100 or fewer audit reports for issuers are, in general, inspected at least once every three

different sizes helps account for the significantly skewed variation in audit firm size present in the audit market. We separate U.S. GNFs because they are much larger than all other firms, and we separate firms having five or fewer inspected issuer engagements because they are much smaller.<sup>323</sup> We use the 2011 through 2020 period because information from earlier inspection years is less comparable and information from later inspection years was not completely available as of the date of our analysis. Information was preliminary for the 2020 inspection year as of the date of our analysis.

5. Our analysis of audit and attestation engagement deficiencies included in annual reports on the PCAOB's interim inspection program related to audits of brokers and dealers below is presented over an eleven-year period. We use the 2011 through 2021 period because 2011 was the first year of the interim inspection program. Information on deficiencies associated with attestation examinations or reviews are not available prior to 2015 because 2015 was the first full year during which the PCAOB was able to review attestation engagements.

### **1. Proxies related to compliance with professional standards**

This subsection presents analyses of three quantitative proxies for the level of compliance with professional standards and thus provides information on the baseline for considering the key potential benefit of the proposed requirements: improved compliance with professional standards. Specifically, we present information on trends in Part I.A deficiencies, QC deficiencies related to audit performance, and broker-dealer engagement deficiencies. Overall, while the quantitative proxies show that some firms have improved compliance with professional standards over time, the analyses also suggest that some firms' QC systems may not be providing the required reasonable assurance. Broker-dealer engagements and issuer audits performed by firms other than U.S. GNFs appear to have the most room for improvement.

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years. Firms that issue audit reports for more than 100 issuers are inspected annually. Therefore, the set of inspected firms and engagements is not fixed year-over-year.

<sup>323</sup> Current PCAOB QC standards recognize that the nature, extent, and formality of a firm's QC policies and procedures should take into account various factors, including the size of the firm. Because PCAOB QC assessments also take into account these factors, the number of QC deficiencies across each of the three categories of firms are not directly comparable. See *The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports*, PCAOB Release No. 104-2006-077 (Mar. 21, 2006), at 9-10.

### **a. Part I.A deficiencies**

Figure 1 presents trends in the percentage of inspected issuer audits having at least one Part I.A deficiency. Staff calculated the Part I.A deficiency rates by dividing the number of inspected issuer audits that had at least one Part I.A deficiency by the number of inspected issuer audits for each given year. The Part I.A deficiency rate is an imperfect proxy for the overall rate of issuer audit deficiencies. It may understate the true rate of issuer audit deficiencies because some deficiencies may not rise to the level of a Part I.A deficiency and because PCAOB inspectors do not inspect all aspects of inspected audits. However, it may also overstate the true rate of issuer audit deficiencies because PCAOB inspectors generally focus their attention on, among other things, audits and audit areas with a heightened risk of material misstatement.

Despite these potential biases in the Part I.A deficiency rate, we believe that the trends in the Part I.A deficiency rates presented in Figure 1 are indicative of underlying trends in issuer audit deficiencies. However, we note two caveats that may impact the interpretation of Figure 1. First, the time trends could be driven in part by changes over time in the proportion of reviewed audits that were selected based on characteristics associated with high-risk audits. Second, PCAOB inspections staff review more focus areas during reviews of U.S. GNF issuer audits than they do during reviews of other firms' issuer audits, increasing the opportunity for a reviewed U.S. GNF issuer audit to have at least one Part I.A deficiency.

For U.S. GNFs, Figure 1 shows that the percentage of inspected issuer audits having at least one Part I.A deficiency has been decreasing since 2013 and was 16% in 2020. For other firms, the percentage has remained in the 30% to 45% range.

**Figure 1. Percentage of Inspected Issuer Audits Having at Least One Part I.A Deficiency (2011-2020)**

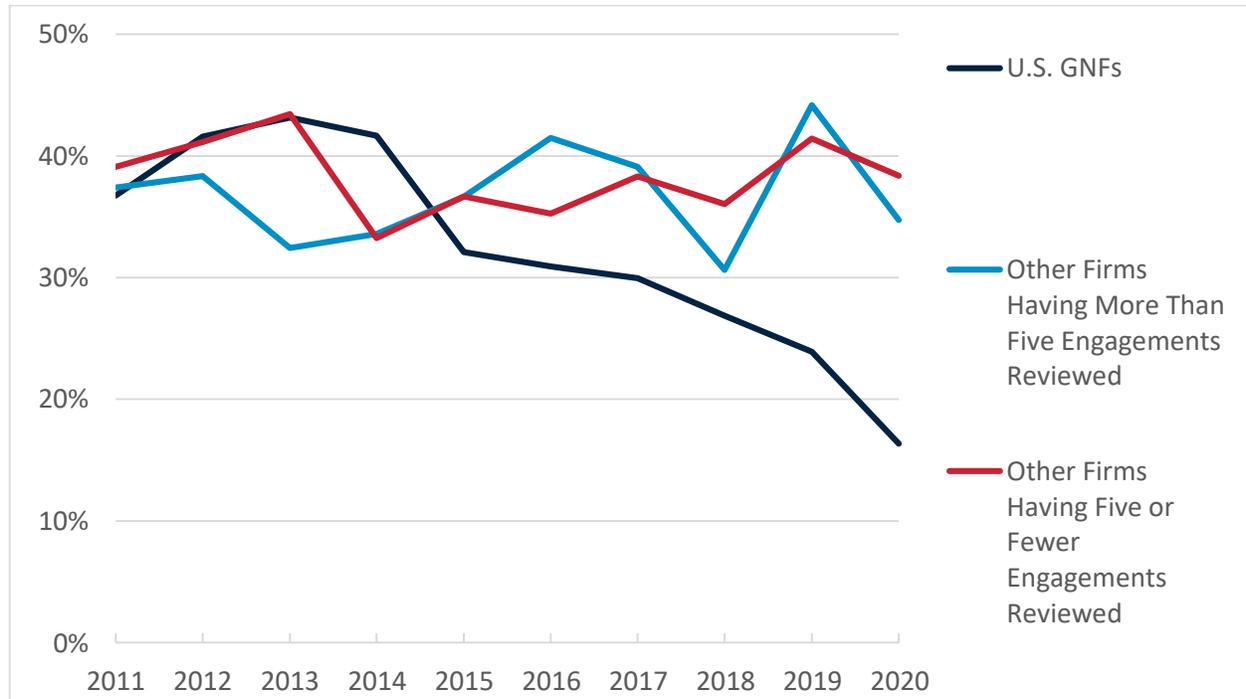
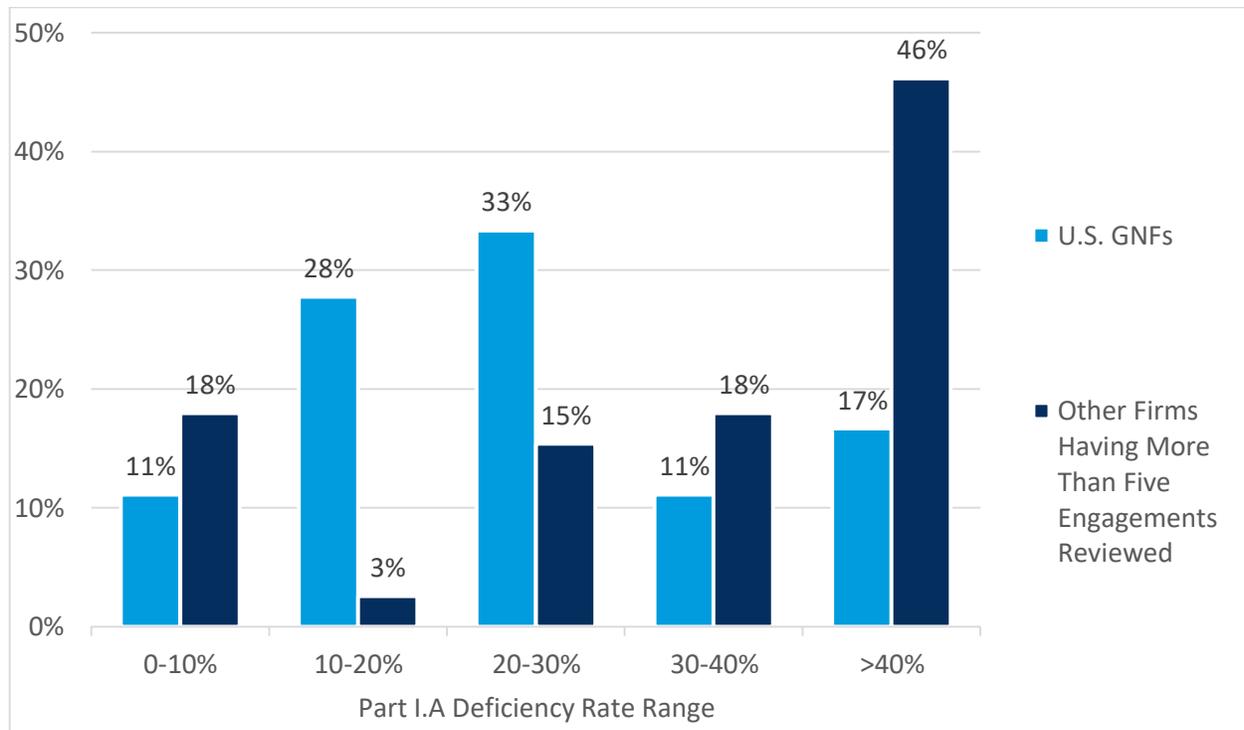


Figure 2 provides additional insight on how the percentage of inspected issuer audits having at least one Part I.A deficiency varies by firm. Each bar indicates the percentage of 2018, 2019, and 2020 firm inspections with a Part I.A deficiency rate within a given range. For example, Figure 2 indicates that 11% of all 2018, 2019, and 2020 U.S. GNP inspections and 18% of all 2018, 2019, and 2020 inspections of other firms with more than five inspected engagements had a Part I.A deficiency rate below 10%. Figure 2 excludes firm inspections with five or fewer inspected engagements because the Part I.A deficiency rate is a less informative proxy in these cases due to the small number of inspected engagements.

**Figure 2. Percentage of Firm Inspections with a Part I.A Deficiency Rate within a Given Range (2018-2020)**



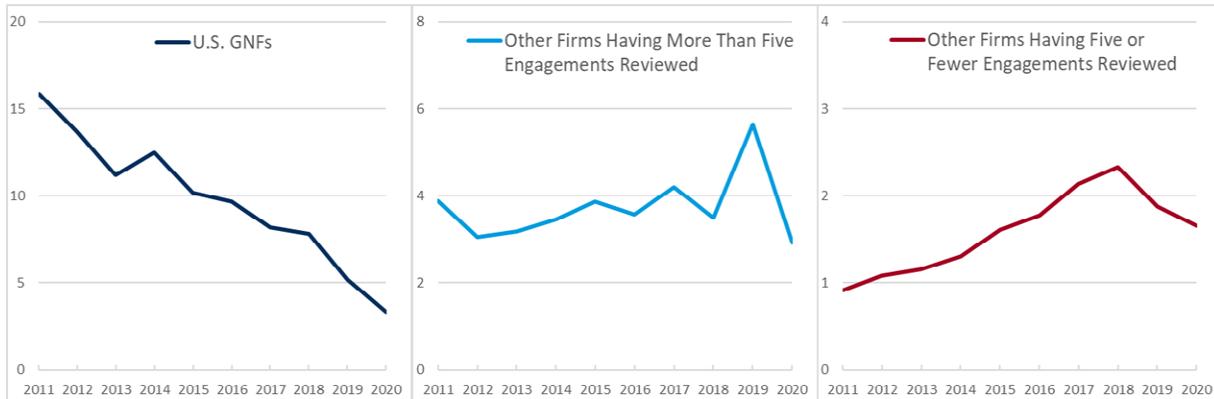
Note: During the 2018, 2019, and 2020 inspection years, there were in total 18 inspections of U.S. GNFS and 39 inspections of other firms having more than five engagements reviewed.

#### **b. QC deficiencies related to audit performance**

Figure 3 presents trends in the average number of QC deficiencies related to audit performance per inspected firm. QC deficiencies related to audit performance are inferred through analysis of inspections of individual audits and thus represent another proxy for the level of compliance with professional standards. To prepare Figure 3, staff counted the number of distinct QC deficiencies related to audit performance that have appeared in Part II of PCAOB inspection reports. Staff assigned a zero to firm inspections which resulted in no QC deficiencies related to audit performance. Staff then calculated averages per inspected firm by year and firm group, assigning equal weight to each QC deficiency regardless of its nature or whether it was a repeat deficiency. While the total number of QC deficiencies for each of the three categories of firms is not readily comparable because of differences in inspection approach, there is a downward trend among U.S. GNFS, while other firms show roughly increasing trends until 2018 or 2019. We note one caveat that may impact the interpretation of Figure 3. Starting in 2019, the PCAOB revised its approach to identifying QC deficiencies related to audit performance. We believe this policy change reduced the number of QC deficiencies related to

audit performance for some of the inspections of non-affiliated firms (“NAFs”) but not for the GNFs.

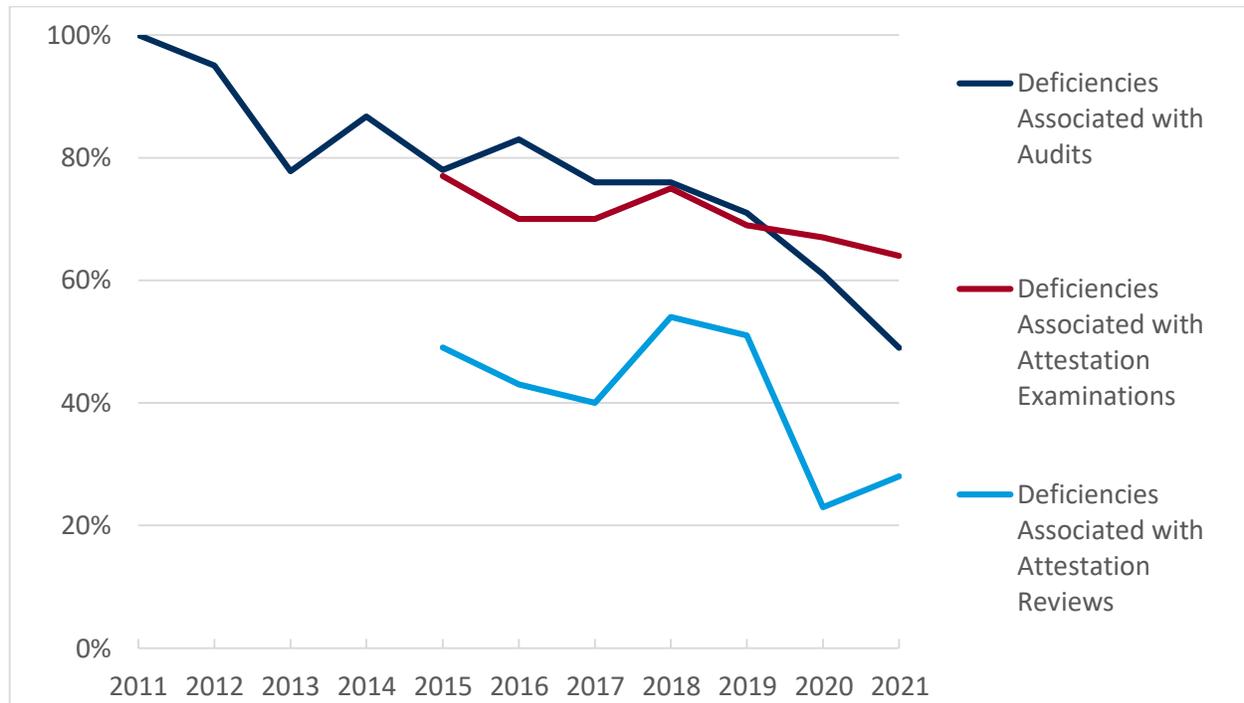
**Figure 3. Average Number of QC Deficiencies Related to Audit Performance Per Inspected Firm (2011-2020)**



**c. Broker-dealer engagement deficiencies**

Figure 4 presents trends in the percentage of broker-dealer audits with deficiencies and the percentage of attestation engagements and reviews with deficiencies. The percentages are reproduced from the PCAOB’s annual reports on the interim inspection program related to the audits of brokers-dealers. The percentages are equal to the number of inspected engagements for which there were deficiencies divided by the number of inspected engagements. Although the trends are decreasing, the percentages of audits and attestation examinations with deficiencies remain greater than 40% in 2021. The percentage of attestation reviews with deficiencies rose from 23% in 2020 to 28% in 2021.

**Figure 4. Percentages of Broker-Dealer Engagements with Deficiencies (2011-2021)**



## 2. Resources associated with QC systems

Firms implement their QC systems through a set of policies and procedures. These policies and procedures vary significantly across firms, reflecting both the principles-based nature of current QC standards and the variation in firms’ particular circumstances. To inform the baseline for considering the potential costs of the proposed requirements, PCAOB staff (1) held initial discussions with U.S. GNFs to obtain qualitative information regarding the resources associated with their QC systems; and (2) conducted a voluntary survey of U.S. GNFs on the resources they employ to design, implement, and operate QC policies and procedures. Overall, the information suggests that U.S. GNFs are already devoting significant resources to the design, implementation, and operation of QC policies and procedures related to the ISQM 1 requirements.

The U.S. GNF survey requested both qualitative and quantitative information for each of the eight QC system components specified by ISQM 1: risk assessment, governance and leadership, independence and ethics, acceptance and continuance, engagement performance, resources (human, intellectual, and technological), information and communication, and monitoring and remediation.<sup>324</sup> In addition, the survey requested qualitative and quantitative information related to network requirements or network services, evaluation of the QC system,

<sup>324</sup> See paragraphs 23, 28, 29, 30, 31, 32, 33 and 35 of ISQM 1.

and documentation.<sup>325</sup> The request referred to ISQM 1 explicitly in order to facilitate comparability of the information gathered across firms and to the proposed QC standard.

All six U.S. GNFs provided qualitative information and five provided quantitative information. Staff received completed surveys between June 23 and July 6, 2021. The respondents provided the information as of their most recently completed fiscal year-end or QC system assessment date.

The qualitative information we received indicates that, among U.S. GNFs, QC policies and procedures are extensive and highly integrated with the audit process. Multiple groups, teams, functions, and individuals participate in the design, implementation, and operation of QC policies and procedures. Engagement teams play a key role in the operation of many QC policies and procedures. Among other QC-related responsibilities, engagement teams often assist in acceptance and continuance decisions; initiate consultations; help maintain accurate and complete information within independence systems; attend training; and initiate and complete individual performance evaluations.

The U.S. GNFs' QC systems involve multiple IT systems that support QC activities and may also serve other operational functions. QC systems may also rely upon work or services provided by the firm's global network and/or third-party vendors. Global network services may relate to development and maintenance of technological and intellectual resources (e.g., global audit methodology, global independence and assurance policies and procedures, etc.) or monitoring the quality of audit services performed by network affiliates. The firms report making ongoing investments in their QC systems, including implementation of new technology that supports QC activities.

The quantitative portion of the survey of U.S. GNFs asked the firms to estimate: (1) the number of firm personnel involved in designing, implementing, or operating QC policies and procedures on an annual basis (by partner vs. non-partner); (2) the percentage of their time committed; and (3) the expected percentage change in QC resource requirements as of December 15, 2022, when ISQM 1 becomes effective.<sup>326</sup> Staff asked the firms to include in their estimates only those resources directly related to the design, implementation, and operation of

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<sup>325</sup> See paragraphs 11 and 57-60 of ISQM 1.

<sup>326</sup> More specifically, staff asked firms to estimate the number of firm personnel who are directly involved in the design, implementation, or operation of each QC system component by commitment level (i.e., <10%, 10-40%, 40-60%, 60-90%, or >90% of the individual's time). If an individual committed time to multiple QC system components, staff asked firms to count the individual once for each QC component and to indicate the time committed to each component. For example, if an individual committed 100% of their time to the firm's QC system, 50% to acceptance and continuance and 50% to monitoring and remediation, firms were asked to count the individual under the 40-60% commitment level for both components.

QC policies and procedures over audits of U.S. issuers and broker-dealers. In cases where removing time spent on QC policies and procedures related to audits of private companies was prohibitively difficult or impossible, staff asked firms to include this time in their estimates and describe the inseparable portion. Firms reported that their QC policies and procedures generally apply across their entire audit practice and thus their estimates typically included resources dedicated to QC systems over engagements performed under PCAOB standards as well as engagements performed under other QC standards.

In initial discussions with the U.S. GNFs, firms reported that identifying all firm personnel hours related to their QC systems would be an enormous challenge. To make the data request feasible, staff directed firms to exclude from their quantitative estimates time spent by engagement teams executing QC policies and procedures (e.g., performing independence procedures, planning for or engaging in consultations, executing the firm's methodology) and facilitating internal inspections. Staff also asked firms to exclude: (1) time spent by firm personnel attending training; (2) time spent by individuals on compliance with personal independence policies and procedures; (3) time spent performing engagement quality reviews of individual engagements; and (4) any resources invested at the global network level to design, implement, or operate QC policies or procedures. The qualitative information that we received from the firms suggests that these aspects of their QC systems are likely resource-intensive.

Table 1 summarizes the quantitative information we received in aggregate form. It presents the means and standard deviations of partner, non-partner, and total full-time equivalents (FTEs) by QC system component.<sup>327</sup> The means provide a sense of average scale while the standard deviations provide a sense of average variability across the firms. Overall, the means presented in Table 1 indicate that U.S. GNFs commit significant resources to designing, implementing, and operating their QC policies and procedures. QC policies and procedures related to (1) independence and ethics and (2) human, intellectual, and technological resources are particularly resource-intensive. Non-partner FTEs are roughly 3.5

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<sup>327</sup> To calculate the means presented in Table 1, staff summed the number of individuals directly involved in the design, implementation, or operation of each QC system component, weighting individuals by the mid-point of their respective commitment level, and divided by the number of firms that were able to provide data for the respective QC system component. The "Total" row mean is equal to the number of individuals directly involved in the design, implementation, or operation of any QC system component, weighting individuals by the mid-point of their respective commitment level divided by five (i.e., the number of firms that provided quantitative information). Therefore, the "Total" row mean does not equal the sum of the QC component-level means. The standard deviations presented in Table 1 were calculated without Bessel corrections. The standard deviation for the "Other" component is equal to the geometric mean of the standard deviations of the network requirements or network services, evaluation of the system of quality management, and documentation components. Our data is insufficient to account for potential covariances between these components.

times partner FTEs, but partners play a relatively larger role in the governance and leadership, engagement performance, and monitoring and remediation components of QC systems. The standard deviations presented in Table 1 indicate significant variability across firms for some of the QC system components, particularly non-partner staff committed to the independence and ethics component and the resources component.

The mean “Total” row values presented in Table 1 may include some underestimation error for several reasons. First, some firms were unable to reasonably estimate all of the resources for certain components, most notably for the governance and leadership component. Second, firms were generally unable to reliably estimate the cost of IT infrastructure that supports the QC system. Third, firms were generally unable to reliably estimate the portion of common-pool resources attributable to the QC system that support broader operational or financial objectives of the firm. Fourth, due to estimation challenges as described above, firms were directed to exclude certain resources from their estimates, including time spent by engagement teams executing QC policies and procedures and time spent by firm personnel attending training.

By contrast the mean “Total” row values may also include some overestimation error. For example, firms broadly reported that their QC policies and procedures apply to both issuer and non-issuer audits and it would generally be infeasible to identify firm personnel hours related to quality control over issuer audits only. In these cases, staff asked firms to include both issuer and non-issuer QC hours in their estimates.

Some firms were unable to separately break out the level of resources committed to designing, implementing, and operating QC policies and procedures for risk assessment, information and communication, network requirements or network services, evaluation of the system of quality management, and documentation. These firms distributed these resources across the remaining components. While this leads to some overestimation error to the remaining components, the information provided by the firms that were able to separately break out these components indicates that these components are relatively less resource-intensive and, therefore, the overestimation error is likely small. This overestimation error does not apply to the mean “Total” row values because any errors in how the firms allocated across components nets out when summing.

**Table 1. Resources Associated with U.S. GNFs QC Policies and Procedures**

	Partner (FTEs)		Non-Partner (FTEs)		Total (FTEs)	
	Mean Per Firm	St. Dev	Mean Per Firm	St. Dev	Mean Per Firm	St. Dev
Risk Assessment	2.1	1.4	4.6	2.3	6.7	2.4
Governance and Leadership	10.0	5.8	9.2	9.3	19.2	14.7
Independence and Ethics	17.7	15.7	172.2	164.2	189.9	173.9
Acceptance and Continuance	11.5	6.1	13.7	13.8	25.2	14.2
Engagement Performance	38.9	23.1	52.8	29.0	91.7	49.0
Resources	42.4	36.6	210.2	267.0	252.6	295.2
Information and Communication	2.6	2.6	8.6	3.3	11.2	4.9
Monitoring and Remediation	22.1	7.1	34.9	15.1	56.9	21.1
Other <sup>328</sup>	4.1	0.6	11.6	2.5	15.6	2.8
<b>Total</b>	<b>143.6</b>	<b>85.3</b>	<b>504.3</b>	<b>428.9</b>	<b>647.9</b>	<b>499.9</b>

Most U.S. GNFs were unable to provide precise estimates regarding expected future changes in QC system resource requirements as of December 15, 2022, when ISQM 1 becomes effective. The qualitative information provided by the firms indicates that: (1) additional resources will likely be required; (2) some of the U.S. GNFs have assigned teams to manage ISQM 1 implementation; and (3) the risk assessment component and the evaluation of the system of quality management component will likely require the most significant additional resources.

### 3. Developments in firms' QC policies and procedures

This subsection provides information on the evolution of firms' QC policies and procedures. First, it describes changes firms have made to their QC policies and procedures to remediate QC deficiencies identified in inspection reports. Second, it presents analysis of trends in QC deficiencies related to firms' management of their audit practices. QC deficiencies related to firms' management of their audit practice relate to the operation of QC policies and procedures. Overall, the information suggests that QC policies and procedures are advancing. While not all firms' QC systems appear to be providing reasonable assurance that their engagements comply with professional standards, we believe that firms' advances in their QC policies and procedures have been partly responsible for some reduction in audit deficiencies.<sup>329</sup>

<sup>328</sup> The "Other" category includes network requirements or network services, evaluation of the system of quality management, and documentation.

<sup>329</sup> For additional discussion, see Section VI.C.1 below.

Over time, many firms have implemented a significant number of changes to their QC systems to remediate their QC deficiencies.<sup>330</sup> Changes brought about through remediation are wide-ranging and can touch upon all major elements of the current QC standards. The nature, extent, and formality of changes made by a firm vary based on the size of the firm and the nature and complexity of its practice. Examples of changes made by various types of firms include:<sup>331</sup>

- Adding in-process review and coaching programs to assist engagement teams in certain challenging areas, including ICFR and accounting estimates;
- Creating a committee to evaluate partner performance in relation to audit quality and issuing an accountability framework with penalties for negative audit quality events;
- Implementing a new template that includes guidance to facilitate the assessment and documentation of partner performance, including guidance related to various performance metrics (such as technical knowledge; leadership and training skills; and compliance with firm quality control policies and procedures);
- Requiring audit partners to articulate specific actions they will take to achieve performance goals related to audit quality and providing additional guidance and information around partner workload management;
- Implementing new policies and procedures for engagement teams to focus on obtaining a thorough understanding of how issuers initiate, record, process, and report significant classes of transactions and how that information is recorded in the financial statements;
- Hiring external consultants to work with the firm to develop a new internal control over financial reporting audit approach;
- Adding new leadership positions to the internal inspection program, developing new analysis and reporting of internal inspection findings, and beginning to disseminate findings more broadly;

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<sup>330</sup> Additional information about the PCAOB remediation process is available on the PCAOB website at [https://pcaobus.org/oversight/inspections/remediation/remediation\\_process](https://pcaobus.org/oversight/inspections/remediation/remediation_process).

<sup>331</sup> Examples are drawn from firms' Rule 4009 submissions. A Rule 4009 submission is a submission prepared by a firm, pursuant to PCAOB Rule 4009, concerning the ways in which a firm has addressed a QC criticism. For additional background, see PCAOB Release No. 104-2006-077.

- Creating a committee to provide oversight on the firm’s audit quality initiatives and a new leadership position to drive consistency across regions; and
- Implementing new templates that provide guidance related to performing a root cause analysis, including identifying areas of a firm’s quality control process to perform causal analysis, collecting relevant data, and documenting the results.

We have taken these observations into account in developing the requirements of proposed QC 1000.

Figure 5 presents trends in the average number of QC deficiencies related to firms’ management of their audit practice per inspected firm. To prepare Figure 5, staff counted the number of distinct QC deficiencies related to firms’ management of their audit practice that have appeared in Part II of PCAOB inspection reports. Staff assigned a zero to firm inspections which resulted in no QC deficiencies related to the firm’s management of its audit practice. Staff then calculated averages per inspected firm by year and firm group, assigning equal weight to each QC deficiency regardless of its nature or whether it was a repeat deficiency. While the total number of QC deficiencies for each of the three categories of firms are not readily comparable, all three curves generally indicate a decreasing trend.

**Figure 5. Average Number of QC Deficiencies Related to Firms’ Management of Their Audit Practice per Inspected Firm (2011-2020)**



#### 4. Academic literature on quality-threatening behaviors and quality control

In this subsection, we discuss academic research on behaviors that suggest certain weaknesses in QC systems in practice. Over time, researchers have documented a variety of quality-threatening behaviors, including “premature sign-off of audit procedures, failure to perform required procedures, inappropriate reductions in substantive testing or other forms of under-auditing, underreporting of time, inadequate adjustments of audit procedures in

response to changing risk conditions, and over-reliance on management explanations of unusual deviations in analytical procedures.”<sup>332</sup>

Research suggests that quality-threatening behaviors imply a failure of QC systems to provide reasonable assurance of compliance.<sup>333</sup> Moreover, some research suggests that, while not solely responsible, certain features of firms’ management of their audit practice may encourage quality-threatening behaviors.<sup>334</sup> For example, experimental research suggests that certain cognitive biases in auditor evaluation and reward systems may inadvertently deter appropriate professional skepticism<sup>335</sup> and other studies suggest that partner reward systems at some firms may weight revenue generation more heavily than professional competencies.<sup>336</sup> Some research finds that reward systems oriented toward revenue generation are associated with lower proxies for audit quality.<sup>337</sup>

An excessive focus on commercial objectives may also lead to undue focus on cost-control in the execution of audits. For example, in one study, audit staff report working, on average, five hours per week, and sometimes 20 hours per week, past the threshold where they feel audit quality begins to deteriorate.<sup>338</sup> In another study, audit staff report working on

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<sup>332</sup> Monika Causholli and W. Robert Knechel, *An examination of the credence attributes of an audit*, *Accounting Horizons* 26.4 (2012), at 647.

<sup>333</sup> See, e.g., Jean C. Bedard, Donald R. Deis, Mary B. Curtis, and J. Gregory Jenkins, *Risk monitoring and control in audit firms: A research synthesis*, *Auditing: A Journal of Practice & Theory* 27.1 (2008), 187-218.

<sup>334</sup> See, e.g., David P. Donnelly, Jeffrey J. Quirin, and David O'Bryan, *Attitudes toward dysfunctional audit behavior: The effects of locus of control, organizational commitment, and position*, *Journal of Applied Business Research*, 19.1 (2003), 95-108.

<sup>335</sup> See, e.g., Joseph F. Brazel, Scott B. Jackson, Tammie J. Schaefer, and Bryan W. Stewart, *The outcome effect and professional skepticism*, *The Accounting Review* 91.6 (2016), 1577-1599.

<sup>336</sup> See, e.g., Marie-Laure Vandenhaute, Kris Hardies, and Diane Breesch, *Professional and commercial incentives in audit firms: Evidence on partner compensation*, *European Accounting Review* 29.3 (2020), 521-554.

<sup>337</sup> See, e.g., Jürgen Ernstberger, Christopher Koch, Eva Maria Schreiber, and Greg Trompeter, *Are Audit Firms' Compensation Policies Associated With Audit Quality?* *Contemporary Accounting Research* 37.1 (2020), 218-244; Thomas Riise Johansen and Jeppe Christoffersen, *Performance evaluations in audit firms: Evaluation foci and dysfunctional behavior*, *International Journal of Auditing* 21.1 (2017), 24-37.

<sup>338</sup> Julie S. Persellin, Jaime J. Schmidt, Scott D. Vandervelde, and Michael S. Wilkins, *Auditor perceptions of audit workloads, audit quality, and job satisfaction*, *Accounting Horizons* 33.4 (2019), 95-117.

average 72 hours per week during busy season.<sup>339</sup> Other research finds that a heavier workload in the fieldwork phase of the audit is negatively associated with proxies for audit quality<sup>340</sup> and that high levels of time pressure are positively associated with audit quality threatening behaviors.<sup>341</sup>

## 5. Assumptions regarding the baseline

Absent the proposed requirements, our preliminary understanding is that many firms will continue to design and implement new QC policies and procedures or modify existing QC policies and procedures in response to evolving audit market conditions, technological advances, PCAOB oversight activities, internal monitoring, and actions of other standard setters.<sup>342</sup> We expect most firms to implement a single QC system over their entire audit practice that will comply with either ISQM 1 or SQMS 1. PCAOB-registered firms with an international presence or that are part of a global network will likely find it efficient to design and implement a QC system that complies with both PCAOB standards and ISQM 1 and have that system operate over their entire assurance practice. For similar reasons, PCAOB-registered firms with a private company audit practice will likely find it efficient to design and implement a QC system that complies with both PCAOB standards and SQMS 1 and have that system operate over their entire assurance practice.

Supporting our preliminary view, comment letters on the concept release suggest that some firms are in the process of designing and implementing QC policies and procedures consistent with the requirements of other QC standards. For example, one firm commented that its global network is in the process of implementing a more proactive, objectives-based approach to quality management and that the QC system of the network and the member firms would continue to evolve due to the pace of change in the environment in which audits are conducted. The firm also reports focusing on enhancing its root cause analysis, performing preissuance engagement reviews prior to issuing audit reports, and embedding performance measures to support achieving quality objectives. Another firm commented that member firms of its global network have begun taking steps to reassess their QC systems to align with international developments, including designing and implementing a globally consistent risk

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<sup>339</sup> Dana R. Hermanson, Richard W. Houston, Chad M. Stefaniak, and Anne M. Wilkins, *The work environment in large audit firms: Current perceptions and possible improvements*, Current Issues in Auditing 10.2 (2016), A38-A61.

<sup>340</sup> See, e.g., Brant E. Christensen, Nathan J. Newton, and Michael S. Wilkins, *How do team workloads and team staffing affect the audit? Archival evidence from US audits*, Accounting, Organizations and Society 92 (2021), 1-20.

<sup>341</sup> See, e.g., Tobias Svanström, *Time pressure, training activities and dysfunctional auditor behaviour: evidence from small audit firms*, International Journal of Auditing 20 (2016), 42-51.

<sup>342</sup> See Section II.D above for additional background on the actions of other standard setters.

assessment process, redesigning a global monitoring approach, and considering requirements for an annual evaluation of quality control. Some commenters also explained that the extent of these efforts varies depending on the size and complexity of the firm.

Our preliminary view is also informed by several public information sources. First, the AICPA website indicates that most registered firms that are headquartered in the U.S. and signed an issuer or broker-dealer audit opinion in 2021 were reviewed as part of the AICPA's Peer Review program since 2019 and therefore were required to comply with AICPA QC standards at that time.<sup>343</sup> Second, among the U.S.-headquartered firms that signed an issuer or broker-dealer audit opinion in 2021 but were not peer reviewed since 2019, most indicate on their webpage that they perform audits or tax services that require them to comply with AICPA QC standards. Third, most foreign jurisdictions require companies to have a statutory audit performed. We believe this suggests that most registered firms headquartered in foreign jurisdictions likely perform audits under IAASB QC standards. Finally, firms' annual reports filed with the PCAOB on Form 2 for the April 1, 2020 through March 31, 2021 reporting period indicate that most firms collected fees for services aside from the performance of issuer audits and therefore may have performed services subject to either AICPA or IAASB QC standards during that time. Overall, we believe these public information sources support our preliminary view that most firms will be complying with either ISQM 1 or SQMS 1. Furthermore, most firms that will not be complying with ISQM 1 or SQMS 1 would likely be scaled-applicability firms and therefore less impacted by the proposed requirements.

## Questions

81. Are there additional academic studies or data related to the baseline for measuring the potential impacts of the proposed requirements? If so, what are they?
82. Are there additional academic studies or data available related to the resources employed by NAFs or foreign affiliates of GNFs in the design, implementation, and operation of their QC systems? If so, what are they?
83. Are there additional academic studies or data available that could help us approximate the number of firms that will be implementing ISQM 1 or SQMS 1? If so, what are they?

## B. Need

### 1. Introduction and summary

This section discusses the problem that the proposed requirements are intended to address and explains how the proposed requirements would address it. Overall, three

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<sup>343</sup> See AICPA Peer Review webpage.

observations suggest that there is a problem that the proposed requirements would help to address:

- The prevalence of Part I.A deficiencies, QC deficiencies related to audit performance, and deficiencies arising during inspections of broker-dealer engagements, along with recent PCAOB enforcement actions, suggest that some firms' QC systems may not provide reasonable assurance that personnel comply with applicable professional standards and the firm's standards of quality.
- The audit market may not provide sufficient incentives for firms to design, implement, and operate QC systems that provide such reasonable assurance.
- Current PCAOB QC standards do not directly address recent developments in QC, including (1) the evolving and greater use of technology by firms in performing engagements and in relation to QC activities and (2) advancements in quality management thought leadership.

The proposed requirements would help address the problem in two main ways:

- The proposed requirements would require firms' QC systems to more proactively assess risks and monitor and remediate deficiencies.
- The proposed requirements would improve accountability within firms with respect to the reasonable assurance objective.

## **2. Some firms' QC systems may not be providing reasonable assurance**

QC systems are required to provide reasonable assurance that the firm's personnel comply with applicable professional standards and the firm's standards of quality.<sup>344</sup> The three proxies for the level of compliance with professional standards discussed in Section VI.A above—the prevalence of Part I.A deficiencies, QC deficiencies related to audit performance, and deficiencies arising during inspections of broker-dealer engagements—as well as the recent PCAOB enforcement actions discussed in Section II.A.3.a suggest that some firms' QC systems may not be providing the required reasonable assurance.

## **3. The audit market may not provide sufficient incentives for firms to design and implement a QC system that provides reasonable assurance**

A diverse set of investors and other financial statement users need and demand high quality audits. However, certain features inherent to the audit market—namely, the presence

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<sup>344</sup> See Section II.A.2. for more discussion of current regulatory requirements.

of asymmetric information<sup>345</sup> and positive externalities<sup>346</sup> discussed further below—suggest that the prevalence of deficiencies associated with issuer audits and broker-dealer engagements reflects a welfare loss<sup>347</sup> and therefore merits regulatory action.

The company under audit, investors, and other financial statement users cannot easily observe the services performed by an auditor. This information asymmetry creates a risk that, unbeknownst to the company under audit, investors, or other financial statement users, auditors may gather insufficient audit evidence to support their opinion or may otherwise depart from applicable requirements. Economic theory refers to this effect as moral hazard.<sup>348</sup> While this may enable the auditor to do less work and reduce potential conflicts with company management, and may therefore lead to short-run benefits for the auditor, it also may lead to a net welfare loss in the audit market as a whole.

A positive externality inherent to the current audit market may exacerbate this risk. The services of an auditor provide a significant benefit to a variety of investors and financial statement users, including current shareholders, potential shareholders, investors in other companies, creditors, and regulators, among others. However, auditors do not bargain with all of these parties. Rather, auditors are retained, dismissed, and compensated by the company under audit. Sarbanes-Oxley requires that the audit committee be responsible for the appointment, compensation, and retention of the auditor.<sup>349</sup> However, in practice, management may also play a role through its influence over the audit committee.<sup>350</sup> This

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<sup>345</sup> See Gregory N. Mankiw, *Principles of economics*, Cengage Learning, 6<sup>th</sup> edition (2008) at 468 (“A difference in access to relevant knowledge is called an information asymmetry.”).

<sup>346</sup> See *id.* at 196 (“An externality arises when a person engages in an activity that influences the well-being of a bystander but neither pays nor receives any compensation for that effect... If it is beneficial, it is called a positive externality.”).

<sup>347</sup> See *id.* at 145 (“Consumer surplus and producer surplus are the basic tools that economists use to study the welfare of buyers and sellers in a market. Consumer surplus is the benefit that buyers receive from participating in a market, and producer surplus is that benefit that sellers receive. It is therefore natural to use total surplus as a measure of society’s economic well-being... Total surplus in a market is the total value to buyers of the goods, as measured by their willingness to pay, minus the total cost to sellers of providing those goods.”).

<sup>348</sup> See *id.* at 468 (“Moral hazard is a problem that arises when one person, called an agent, is performing some task on behalf of another person, called the principal. If the principal cannot perfectly monitor the agent’s behavior, the agent tends to undertake less effort than the principal considers desirable.”).

<sup>349</sup> See Section 301 of Sarbanes-Oxley.

<sup>350</sup> See, e.g., Liesbeth Bruynseels and Eddy Cardinaels, *The audit committee: Management watchdog or personal friend of the CEO?*, *The Accounting Review* 89.1 (2014), at 114 (finding that social

creates a *de facto* principal-agent relationship between the company and the auditor. Moreover, some beneficiaries of the auditor's work (e.g., investors generally, who benefit from overall confidence in the quality of financial information provided to the market) may have no influence on the auditor at all. Economic theory suggests that, in the presence of positive externalities such as these, markets may undersupply goods or services.<sup>351</sup> As a result, the positive externality in the audit market may create an additional risk that auditors may gather insufficient audit evidence to support their opinion or otherwise depart from applicable requirements.

A firm also faces its own management challenges in implementing its desired service, economic, and regulatory compliance objectives. Individual offices or personnel may have incentives that diverge from the firm's collective best interest. For example, some research suggests that certain partners or offices may be commercially dependent on significant clients and may be willing to take risks to retain those clients that the firm as a whole would not—a form of free riding on the firm's reputation and capacity to absorb potential litigation costs.<sup>352</sup> Even if QC systems were able to align the incentives of individual offices and personnel to the firm's collective best interest, some research suggests that behavioral biases (e.g., confirmation bias, over-optimism, and anchoring bias) may lead offices or personnel to act in ways contrary to both their own self-interest and the firm's collective best interest.<sup>353</sup>

Some firms may manage these challenges by adopting centralized control practices that may have ambiguous impacts on their QC system. For example, academic research suggests that firms carefully screen new partners to act in the best interest of the firm<sup>354</sup> and emphasize meeting engagement budgets—an easily monitored metric that ties directly to profitability.<sup>355</sup> Investors, financial statement users, and companies under audit may have trouble monitoring

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ties between management and the audit committee are present in 39% of the companies in their sample and “may reduce the quality of the audit committee's oversight”).

<sup>351</sup> See, e.g., Mankiw, *Principles* Chapter 10 (“In the presence of a positive externality, the social value of the good exceeds the private value. The optimal quantity is therefore larger than the equilibrium quantity... Positive externalities lead markets to produce a smaller quantity than is socially desirable.”).

<sup>352</sup> See, e.g., Robert A. Prentice, *The case of the irrational auditor: A behavioral insight into securities fraud litigation*, *Nw. UL Rev.* 95.1 (2000), 133-219.

<sup>353</sup> See, e.g., Prentice, *The case* 133-219.

<sup>354</sup> See, e.g., C. J. McNair, *Proper compromises: The management control dilemma in public accounting and its impact on auditor behavior*, *Accounting, Organizations and Society* 16.7 (1991), 635–653.

<sup>355</sup> See, e.g., Bernard Pierce and Breda Sweeney, *Cost-quality conflict in audit firms: an empirical investigation*, *European Accounting Review* 13.3 (2004), 415-441.

how firms incentivize, implement, and monitor compliance with applicable professional and legal requirements. The monitoring challenges faced by investors, financial statement users, and the companies under audit, as well as the lack of specificity in current PCAOB QC standards, give firms the flexibility to implement QC systems that may not fully meet the interests of investors and financial statement users.

#### **4. Current PCAOB QC standards do not directly address market and other developments**

Section II.B above discusses developments in the auditing environment since the development of the current QC standards by the AICPA and subsequent adoption of these standards on an interim basis by the Board. In brief and as discussed above, the audit market has changed significantly since the AICPA developed the PCAOB's current QC standards in 1997. At that time, the audit market was largely self-regulated by firms and QC inspections were performed through a peer review program. Since then, PCAOB oversight has led firms to address deficiencies identified during inspections, including making changes to their QC systems to remediate QC deficiencies.<sup>356</sup> There have also been significant developments in technology used by firms in relation to QC practices and audit performance. For example, better IT systems have given auditors quicker access to documentation and the ability to store and quickly retrieve vast amounts of data. Thought leadership in quality management has also advanced,<sup>357</sup> as have the QC standards adopted by other standard setters.

The Board believes that the current PCAOB QC standards do not sufficiently reflect these developments. To be sure, our analysis of PCAOB inspection activities does suggest that some improvements in audit performance have followed from remedial changes firms have made to their QC systems<sup>358</sup> and that some firms have already significantly reduced the number of QC deficiencies related to management of their audit practice.<sup>359</sup> However, the Board continues to observe significant rates of audit performance deficiencies<sup>360</sup> and believes that further enhancements to the current QC standards would address these audit performance deficiencies and help firms more consistently comply with applicable professional and legal requirements and achieve the reasonable assurance objective.

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<sup>356</sup> See Section VI.A.3 above.

<sup>357</sup> See, e.g., COSO, ISO 9000, and the audit firm governance codes of the UK Financial Reporting Council and Japan Financial Services Agency.

<sup>358</sup> This point is discussed more fully in Section VI.C.1 below.

<sup>359</sup> See Figure 5 in Section VI.A.3.

<sup>360</sup> See Figures 1 and 2 in Section VI.A.1.

## 5. How the proposed requirements would better address the need

The proposed requirements would provide substantial additional direction to firms regarding the design, implementation, and operation of their QC systems. We describe two overarching features of the proposed requirements that we believe would address the need for standard-setting described above. The first pertains to the mandate for a more integrated, proactive, and risk-based QC system and the second pertains to the enhancements to accountability within the firm to achieve the reasonable assurance objective.

Regarding the first feature, the proposed new risk assessment process, coupled with a detailed monitoring and remediation process, would together form a feedback loop designed to foster a proactive approach to QC that drives continuous improvement. For example, the risk assessment process would require the firm to obtain an understanding of the conditions, events, and activities that may adversely affect the achievement of its quality objectives; identify and assess quality risks; and then design and implement quality responses. The monitoring and remediation process would help the firm evaluate whether the QC system is working effectively in practice. This more proactive approach to QC should help address the positive externality problem in the audit market by leading firms to implement QC systems that would more consistently satisfy the interests of all beneficiaries of the audit. Additionally, as discussed above in Section VI.B.3, information asymmetry may cause investors not to have sufficient information to understand whether their issuer's audit firm has an effective QC system that consistently produces high-quality audits, and investors may not have a sufficient voice in the financial reporting ecosystem to be able to demand or incentivize audit firms to implement one. Requiring the auditor to implement a robust QC system would substitute a compliance incentive for the potentially insufficient market incentive.

Regarding the second feature, we believe the proposed QC standard would improve accountability within the firm to achieve the reasonable assurance objective. Several of the proposed requirements that would improve accountability within the firm address the positive externality problem directly by leading firms to implement QC systems that would more consistently satisfy the interest of all beneficiaries of the audit. For example, the proposed QC standard would require the firm to document and assign roles and responsibilities; communicate information related to the monitoring and remediation process to firm personnel to enable them to take timely action in accordance with their responsibilities; and establish a quality objective to incentivize individuals to fulfill their assigned responsibilities. Leadership would also be accountable for the design, implementation, and operation of the firm's QC system and the firm would be required to establish a quality objective that leadership communicate and promote the firm's role in protecting the interests of investors and the public interest. Several of the proposed requirements that would improve accountability within the firm address the information asymmetry problem by requiring firms to disclose additional or higher-quality information regarding the nature and effectiveness of their QC systems. For example, the proposal would require the firm to communicate to the audit committee and the

PCAOB the conclusion of the firm's most recent annual QC system evaluation and the firm's QC system would operate over any public reporting regarding firm or engagement performance metrics that the firm would provide. Overall, this second feature reinforces the first by adding an additional incentive that is personal to responsible individuals within the firm that would reinforce the general incentives for the firm to comply with the standard.

## Question

84. Should we consider any additional academic studies or data related to the need for standard setting?

### C. Economic Impacts

This section discusses the potential benefits, costs, and unintended consequences that may result from the proposed requirements. We highlight the impacts of several key provisions. These provisions relate to scaled applicability, in-process monitoring activities, firm governance structure, reporting the annual QC system evaluation, certification of the annual QC system evaluation, responding to engagement deficiencies identified after issuance of the audit report, and SECPS requirements. While the analysis of economic impacts is largely qualitative in nature, it does, in part, use PCAOB inspections data to help evaluate potential benefits. Technical details regarding quantitative analysis of potential benefits are included in a separate staff white paper.<sup>361</sup>

The economic impacts of the proposed requirements would arise out of changes firms would make to their QC systems that they would not otherwise make but for the proposed requirements. As discussed in Section VI.A. above, we expect that, absent the proposed requirements, many firms would continue to make changes to their QC systems in response to evolving audit market conditions, advances in technology, PCAOB oversight activity, internal monitoring, and the actions of other standard setters. This would have the effect of attenuating both the benefits and the costs attributable to the proposed requirements. As several commenters on the concept release noted, the precise impact of the proposed requirements is difficult to forecast and would likely vary considerably by firm.

#### 1. Benefits

We describe the potential benefits of the proposed requirements using four complementary views: (a) the benefits of quality management frameworks generally; (b) the direct benefits of the proposed requirements in the form of improved compliance with applicable requirements; (c) the indirect benefits of the proposed requirements in the form of

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<sup>361</sup> See *Staff White Paper, The Impact of Quality Control System Remediation on Audit Performance and Financial Reporting Quality* (Nov. 18, 2022), available on the Board's website in Docket 046.

improved financial reporting quality and capital market efficiency; and (d) the benefits of key provisions.

#### **a. Benefits of related frameworks**

The proposed QC standard would bear significant resemblance to existing quality management and enterprise risk management frameworks (e.g., ISO 9000 and COSO). These frameworks share several features in common with the proposed QC standard, including embedding risk in decision making, proactive involvement of leadership, clearly defined objectives, objective-oriented processes, monitoring, and remediation. Using a variety of proxies (e.g., market reaction), academic research has found that these frameworks improve company performance.<sup>362</sup> In particular, researchers have found that the COSO framework—the closest antecedent to the proposed QC standard—effectively improves financial reporting.<sup>363</sup> Similarly, research finds that markets penalize public companies with weaker internal control systems and reward the remediation of those weaknesses.<sup>364</sup> While differences between the proposed QC standard and existing frameworks as well as differences between audit firms and other companies may limit the relevance of this research to some extent, this research suggests that the proposed QC standard may help firms design, implement, and operate more effective QC systems.

#### **b. Improved compliance with applicable professional and legal requirements**

We believe the proposed requirements would improve compliance with applicable professional and legal requirements. As described in Section VI.B.5 above, the proposed requirements would achieve this through two principal mechanisms. First, they would explicitly connect the components of the QC system into an integrated cycle of risk assessment, performance monitoring, and remediation. Second, several of the new requirements would support the effectiveness of QC systems by emphasizing accountability to the reasonable assurance objective. Several commenters on the concept release described how a risk-based QC standard would improve audit quality. Broker-dealer engagements and issuer audits

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<sup>362</sup> See, e.g., Iñaki Heras-Saizarbitoria and Olivier Boiral, *ISO 9001 and ISO 14001: towards a research agenda on management system standards*, *International Journal of Management Reviews* 15.1 (2013), 47-65; Robert E. Hoyt and Andre P. Liebenberg, *The value of enterprise risk management*, *Journal of Risk and Insurance* 78.4 (2011), 795-822.

<sup>363</sup> See, e.g., Hanwen Chen, Wang Dong, Hongling Han, and Nan Zhou, *A comprehensive and quantitative internal control index: construction, validation, and impact*, *Review of Quantitative Finance and Accounting* 49 (2017), 337-377; Ifeoma Udeh, *Observed effectiveness of the COSO 2013 framework*, *Journal of Accounting & Organizational Change* 16.1 (2019), 41-45.

<sup>364</sup> See, e.g., Hollis Ashbaugh-Skaife et al., *The effect of SOX internal control deficiencies on firm risk and cost of equity*, *Journal of Accounting Research* 47.1 (2009), 1-43.

performed by firms other than U.S. GNFs may see more significant improvement because they appear to have the most room for improvement on average.<sup>365</sup>

Staff analysis of PCAOB inspections data supports the view that more effective QC policies and procedures may lead to improved compliance with applicable professional standards. Staff examined the historical association between satisfactory remediation of QC deficiencies and subsequent Part I.A deficiencies for triennial firms.<sup>366</sup> Satisfactory remediation of a QC deficiency reflects substantial good-faith progress toward achieving a quality control objective.<sup>367</sup> As such, an association between historical satisfactory remediation efforts and a subsequent decrease in Part I.A deficiencies would suggest that more effective QC policies and procedures lead to improved compliance with applicable professional standards. After controlling for auditor and issuer characteristics that may also drive Part I.A deficiencies using standard statistical techniques, the staff analysis indicates that, on average, satisfactory remediation is associated with reduced likelihood of subsequent Part I.A deficiencies. This suggests that more effective QC policies and procedures may lead to improved compliance with applicable professional standards.<sup>368</sup>

The analogy between historical satisfactory remediation efforts among triennial firms and implementation of the proposed QC standard by registered firms who would be required to do so is subject to several important caveats. First, remedial actions typically target specific aspects of a firm's QC system. By contrast, implementation of the proposed QC standard may require a broader set of changes. Second, due to the transformational nature of the proposed QC standard, the changes firms would make to their QC systems could be substantially different from firms' historical satisfactory remedial actions. Third, U.S. GNFs were intentionally excluded from the analysis, potentially limiting its applicability to the U.S. GNFs. However, though association does not imply causation, the historical association between the number of QC deficiencies related to U.S. GNFs' management of their audit practice<sup>369</sup> and U.S. GNFs' compliance with professional standards<sup>370</sup> suggests that, even among the U.S. GNFs, more

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<sup>365</sup> See Section VI.A.1.

<sup>366</sup> Firms that issued audit reports with respect to 100 or fewer issuers during the prior calendar year ("triennial firms") must be inspected at least once every three years.

<sup>367</sup> See *Staff Guidance Concerning the Remediation Process* (Nov. 18, 2013), available at [https://pcaobus.org/Inspections/Pages/Remediation\\_Process.aspx](https://pcaobus.org/Inspections/Pages/Remediation_Process.aspx).

<sup>368</sup> For additional details, including definitions of all control variables, see Staff White Paper.

<sup>369</sup> See Figure 5 above in Section VI.A.3 above.

<sup>370</sup> See Figures 1 and 3 in Section VI.A.1 above.

effective QC systems could lead to improved compliance with professional standards.<sup>371</sup> Overall, we expect the association between satisfactory remediation and subsequent Part I.A deficiencies among triennial firms more likely understates the potential impact of the proposed QC standard due to its transformational nature.

Observations from PCAOB inspections and academic research also suggest that the proposed requirements may improve compliance with professional standards. PCAOB inspectors have observed that root cause analyses, effective design and implementation of remedial actions, and appropriate governance practices related to leadership's tone can drive audit quality,<sup>372</sup> and one academic study reports that, as perceptions of the strength of the QC system increase, the likelihood of "reduced audit quality behaviors" decreases.<sup>373</sup> These findings likewise support the view that the proposed requirements, which place greater emphasis on root cause analysis, remediation, and governance practices, if successfully implemented, may lead to improved compliance with professional standards.

### **c. Improved financial reporting quality and capital market efficiency**

Academic research provides significant evidence that compliance with auditing standards is positively associated with proxies for financial reporting quality.<sup>374</sup> Research also finds a significant positive association between firms' successful remediation of QC deficiencies—a proxy for adopting effective QC system practices—and the financial reporting

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<sup>371</sup> Several nuances of smaller firms' QC systems and the PCAOB inspections process may explain the absence of such an association for these firms. First, although we observe a downward trend in QC deficiencies related to management of the audit practice (Figure 5 above), smaller firms' QC systems may be deficient in certain important respects that render them less effective overall. Second, the roughly increasing trend in QC deficiencies related to audit performance for the smallest firms (Figure 3 above) may be driven in part by deficiencies in the application of new auditing requirements by these firms. Third, the inspection approach to QC assessments for the smaller firms is simplified and does not lend itself to such a correlation analysis.

<sup>372</sup> See, e.g., 2018 Inspection Observations Preview at 1., *Building a Foundation for Audit Quality* (Dec. 6, 2017) available at <https://pcaobus.org/News/Speech/Pages/Munter-Building-A-Foundation-for-Audit-Quality.aspx> and *The State of Audit Quality* (Dec. 11, 2015) available at <https://pcaobus.org/News/Speech/Pages/Munter-AICPA-2015-inspections-update.aspx>.

<sup>373</sup> See, e.g., Charles F. Malone and Robin W. Roberts, *Factors associated with the incidence of reduced audit quality behaviors*, *Auditing: A Journal of Practice & Theory* 15.2 (1996), 49-64.

<sup>374</sup> See, e.g., Daniel Aobdia, *Do practitioner assessments agree with academic proxies for audit quality? Evidence from PCAOB and internal inspections*, *Journal of Accounting and Economics* 67.1 (2019), 144-174; Katherine A. Gunny and Tracey Chunqi Zhang, *PCAOB inspection reports and audit quality*, *Journal of Accounting and Public Policy* 32.2 (2013), 136-160.

quality of their issuer clients.<sup>375</sup> Staff analysis also provides some evidence that successful remediation may be associated with improved financial reporting quality.<sup>376</sup>

Investors and financial statement users may benefit from improved issuer financial reporting quality because it helps solve information asymmetries and agency problems inherent to capital markets. Economic theory suggests that markets tend to underperform when buyers cannot easily observe product quality. Such markets tend to attract a disproportionate share of lower-quality sellers because buyers may unwittingly overcompensate them. At the same time, higher-quality sellers tend to be repelled from such markets because buyers cannot differentiate them from lower-quality sellers and compensate them accordingly.<sup>377</sup> Capital markets are susceptible to this type of market failure because investors have difficulty perceiving accurately the investment prospects of all investment opportunities. Economic theory suggests that investors also face a separation-of-ownership-and-control problem whereby issuer management may misappropriate investors' capital.<sup>378</sup> Relevant and accurate financial reporting can alleviate these problems by providing investors and other financial statement users with more accurate information regarding the financial position and operating results of companies. Investors may use this information to improve the efficiency of their capital allocation decisions (e.g., investors may reallocate capital from less profitable companies to more profitable companies). Investors may also perceive less risk in capital markets generally, leading to an increase in the supply of capital. An increase in the supply of capital could increase capital formation while also reducing the cost of capital to companies.<sup>379</sup> While

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<sup>375</sup> See, e.g., Daniel Aobdia, *The Economic Consequences of Audit Firms' Quality Control System Deficiencies*, *Management Science* 66.7 (2020), 2883-2905.

<sup>376</sup> See Staff White Paper for additional details.

<sup>377</sup> See, e.g., George A. Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, *The Quarterly Journal of Economics* 84.3 (1970), 488-500 (discussing how lower-quality cars (i.e., lemons) may drive out higher-quality cars from the used car market).

<sup>378</sup> See, e.g., Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, *Journal of Financial Economics* 3.4 (1976), 305-360; Adolf Augustus Berle and Gardiner Coit Means, *The Modern Corporation and Private Property*, Transaction publishers (1991).

<sup>379</sup> See, e.g., Richard Lambert, Christian Leuz, and Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, *Journal of Accounting Research* 45.2 (2007) at 387 (discussing how "...increasing the quality of mandated disclosures should in general move the cost of capital to the risk-free rate for all firms in the economy") and William Robert Scott and Patricia C. O'Brien, *Financial Accounting Theory*, Vol. 3, Prentice Hall, (2003) at 412 ("Information asymmetry is thus frequently used to justify regulation to protect the information disadvantaged... such regulations are also intended to improve the operation of capital markets by enhancing public confidence in their fairness. An important role of accounting and auditing is to report relevant and reliable information, thereby reducing information asymmetry between firm insiders, the investing public, and other users.").

some uncertainty remains regarding the economic impacts of financial reporting,<sup>380</sup> empirical academic research has affirmed this basic premise.<sup>381</sup> Moreover, some studies have identified a direct association between auditors' compliance with PCAOB standards and capital market efficiency.<sup>382</sup>

The proposed requirements may also lead to improved compliance with applicable professional standards and legal requirements on broker-dealer audit engagements and, in turn, improve financial reporting quality and investor protection. An auditor's work on these engagements, if appropriately performed, should make it more likely that a broker-dealer would maintain appropriate controls over compliance and less likely that there would be significant reporting errors. It also has the potential to make it more difficult for broker-dealers to engage in fraud and other misconduct. Improved broker-dealer financial reporting quality also gives industry overseers, such as the SEC and FINRA, as well as other users of broker-dealer financial information, such as the Securities Investor Protection Corporation, more accurate information relevant to a broker-dealer's financial condition, its ability to continue as a going concern, and its handling of customer securities and cash. This, in turn, enhances the ability of these organizations to carry out their responsibilities in ways that protect investors. Compliance with professional standards may also contribute to the early identification or prevention of broker-dealer failures. Failures of large broker-dealers can have a negative impact on the stability and liquidity of financial markets, and failures caused by misconduct may damage investor confidence. A reduction in such failures could help improve the strength and safety of the financial system.

#### **d. Benefits of key provisions**

The proposed QC standard would require that a firm implement and operate an effective QC system at all times when the firm is required to comply with applicable professional and legal requirements with respect to any of the firm's engagements, and

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<sup>380</sup> See, e.g., Christian Leuz and Peter D. Wysocki, *The economics of disclosure and financial reporting regulation: Evidence and suggestions for future research*, *Journal of Accounting Research* 54.2 (2016), 525-622 (explaining the relative rarity of evidence on causal effects of disclosure and reporting regulation); Matthias Breuer, Christian Leuz, and Steven Vanhaverbeke, *Mandated Financial Reporting and Corporate Innovation*. No. w26291. National Bureau of Economic Research, (2020), at 41 (reporting "evidence consistent with the notion that mandatory reporting deters firms' incentives to innovate and generate proprietary know-how because of concerns about the loss of proprietary information").

<sup>381</sup> See, e.g., Christian Leuz and Robert E. Verrecchia, *The economic consequences of increased disclosure*, *Journal of Accounting Research* 38 (2000), 91-124; Utpal Bhattacharya, Hazem Daouk, and Michael Welker, *The world price of earnings opacity*, *The Accounting Review* 78.3 (2003), 641-678.

<sup>382</sup> See, e.g., Nemit Shroff, *Real Effects of PCAOB International Inspections*, *The Accounting Review* 95.5 (2020), 399-433.

thereafter through the next November 30.<sup>383</sup> Section III.C.1 above provides further information on this provision. As of June 30, 2022, up to 59% of firms do not meet this criterion but would be required to design a QC system in compliance with proposed QC 1000.<sup>384</sup> Because registering with the PCAOB enables a firm to issue audit reports or play a substantial role on audits performed under PCAOB standards for issuers and broker-dealers, and because prospective clients and investors could reasonably expect that any firm that could pursue such an engagement would already have a PCAOB-compliant QC system designed and ready for implementation and operation, we believe that imposing a design requirement on all registered firms would promote our mission of protecting investors and promoting the public interest. We also believe that designing the QC system would better position these firms to accept and perform engagements in compliance with applicable professional and legal requirements.

The proposed QC standard would require firms that issue audit reports with respect to more than 100 issuers during the prior calendar year to monitor in-process engagements, and would require all other firms to consider monitoring in-process engagements.<sup>385</sup> Section IV.K.1.c.ii above provides further information on this provision. In summary, monitoring in-process engagements can help firms detect and prevent engagement deficiencies before the engagement report is issued, resulting in a more proactive and preventive monitoring approach.

The proposed QC standard would require firms that issued audit reports with respect to more than 100 issuers during the prior calendar year to incorporate into their governance structure an oversight function for the audit practice that includes at least one person who is not an employee of the firm and does not otherwise have a commercial, familial, or other relationship with the firm that would interfere with the exercise of independent judgment with regard to matters related to the QC system.<sup>386</sup> Section IV.E.1.b above provides further information on this provision. Such an oversight function could reduce negative impacts of commercial considerations on decision making by firms about their QC system and thereby improve incentives to implement QC systems that more fully meet the interests of investors

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<sup>383</sup> See proposed QC 1000.07.

<sup>384</sup> As noted above, approximately 49% of registered firms did not perform an audit of an issuer or broker-dealer in the last five years. We do not collect information about whether registered firms perform engagements under PCAOB standards other than for issuers and broker-dealers. Firms may perform engagements, for example, in connection with the audit of a reporting company that does not meet the Sarbanes-Oxley definition of “issuer” described in footnote 2 above, in connection with certain offerings of securities that are exempt from registration under the Securities Act (e.g., offerings under Regulation A, Regulation D, or Regulation Crowdfunding), pursuant to a contractual obligation such as a loan covenant, or on an entirely voluntary basis.

<sup>385</sup> See proposed QC 1000.63.

<sup>386</sup> See proposed QC 1000.28.

and financial statement users. Some academic research finds that the level of Board independence is associated with benefits.<sup>387</sup>

The proposed QC standard would require firms to report to the PCAOB about the annual evaluation of their QC system. Section IV.L.1.c above provides further information on this provision. As the report would be transmitted to the PCAOB annually, prior to the firm's inspection, this requirement would help the Board obtain more timely, structured, and consistent information regarding the effectiveness of firms' QC systems relative to what could be gathered through the inspections process, especially for the triennial firms. The Board could use this information to support its oversight activities (e.g., to select firms, audits, or focus areas for review). Reporting to the PCAOB may also improve incentives within a firm to design, implement, and operate an effective QC system.

The proposed QC standard would require certain individuals in firms' leadership to certify the annual evaluation of their firm's QC system.<sup>388</sup> Section IV.L.1.c.iii above provides further information on this provision. This requirement would help address the positive externality problem in the audit market by creating greater accountability within firm leadership to implement an effective QC system. The Auditing Standards Committee of the Auditing Section of the American Accounting Association ("AAA") recommended against mandatory QC system certification based on a review of academic literature on the impacts of CEO and CFO certification requirements in the U.S. and engagement partner signature requirements in the United Kingdom. The AAA reported both supportive and unsupportive findings, concluding that the prior research does not provide compelling evidence that QC system certifications would add value. PCAOB staff reviewed this literature and also found both supportive and unsupportive findings.<sup>389</sup> Based on our judgment and the absence of dispositive counterevidence in the academic literature, our preliminary view is that the proposed requirement would benefit investors.

The proposed amendments to AS 2901, *Consideration of Omitted Procedures After the Report Date*, would include: (1) addressing engagement deficiencies rather than omitted procedures and (2) including the ICFR audit within its scope. Relatedly, the proposed

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<sup>387</sup> See, e.g., Anzhela Knyazeva, Diana Knyazeva, and Ronald W. Masulis, *The supply of corporate directors and board independence*, *The Review of Financial Studies* 26.6 (2013), 1561-1605.

<sup>388</sup> See proposed QC 1000.14d. and .15b.

<sup>389</sup> See, e.g., Daniel A. Cohen, Aiyasha Dey, and Thomas Z. Lys, *Corporate Governance Reform and Executive Incentive: Implications for Investments and Risk Taking*, *Contemporary Accounting Research* 30.4 (2013) at 1298 (finding that their sample of "...firms significantly reduced investments in risky projects in the period following SOX") and Hsihui Chang, Jengfang Chen, Woody M. Liao, and Birendra K. Mishra, *CEOs'/CFOs' Swearing by the Numbers: Does it Impact Share Price of the Firm?*, *The Accounting Review* 81.1 (2006) at 22 (concluding that the "...SEC order requiring filing of sworn statements by CEOs and CFOs had a positive effect on the market value of certifying firms").

amendments to AT No. 1 and AT No. 2 would mirror the proposed amendments to AS 2901. Section V.A.2 above provides further information on this provision. We believe these proposed amendments may lead auditors to perform additional procedures to obtain sufficient appropriate evidence or take additional action to prevent future reliance on insufficiently supported audit opinions (or review report in the case of a review engagement) that are being relied on. In such cases, PCAOB standards would require firms to advise their client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements (or examination or review reports in the case of attestation engagements) to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report (or review report in the case of a review engagement). Academic research on ICFR suggests that such disclosures would be valuable to capital market participants.<sup>390</sup>

The proposal would refine, integrate into the proposed QC standard, and extend to all firms the SECPS member requirements currently required under PCAOB Rule 3400T. Based on current registration data, approximately 13% of PCAOB-registered firms are already subject to these requirements under PCAOB Rule 3400T. Section II.A.2.b, above, provided an overview of these requirements. Our preliminary view is that the most significant beneficial impact of this feature of the proposal would be to improve compliance with SEC and PCAOB independence rules on engagements performed by firms not already subject to these requirements under PCAOB Rule 3400T.

## Questions

85. Does our analysis appropriately capture the potential benefits of the proposal? If not, please explain.
86. Are there additional potential benefits that should be considered? If so, what are they?

## 2. Costs

The proposed requirements would likely result in additional costs, both direct and indirect, to auditors and, potentially, to the companies that they audit. The extent of these costs would depend on the degree to which firms would otherwise have QC systems in place designed to comply with other QC standards. The information presented in Section VI.A.2 above, suggests that U.S. GNFs commit hundreds of partner and non-partner FTEs to their QC systems, including, individually, each of the major QC system components specified in ISQM 1. Resources are particularly significant in the areas of independence, ethics, and resources. As discussed in VI.A.5 above, our preliminary view is that most firms are subject to other QC standards. Therefore, we believe that a significant portion of the overall costs of designing,

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<sup>390</sup> See Section IV.C.1.a above and the research cited therein.

implementing, and operating policies and procedures to comply with the proposed QC standard would be incurred by most firms regardless of whether the proposed QC standard is adopted. As a consequence, for most firms, we believe the costs discussed below would derive primarily from the provisions in the proposed standard that go beyond the requirements of other QC standards. However, since QC systems are resource-intensive, the efforts required to respond to the additional provisions in the proposed standard or to otherwise adapt the QC system to the auditing environment for issuers and SEC-registered broker-dealers could be significant.

**a. Direct and indirect costs of the proposed requirements**

The proposed requirements would likely lead to several direct and indirect costs. There would be a direct cost to audit firms to design a QC system that would comply with the proposed standard. For example, firms would likely spend time reviewing the proposed standard; assigning roles and responsibilities; identifying staffing and training needs; and developing a set of quality objectives, quality risks, and quality responses. Some firms may outsource certain aspects of QC system design. However, we believe significant customization would still be necessary to ensure that each QC system design appropriately addresses each firm's needs. The extent of the design costs would likely depend on facts and circumstances unique to each firm. Among firms that will already be complying with other QC standards, which we preliminarily believe represents most firms, the design costs would likely be significantly less and limited to incremental requirements around ethics, independence, monitoring, and remediation.

For full applicability firms—those that would be required to implement and operate an effective QC system—there could be additional costs. Firms may need to implement significant fixed resources (e.g., people, financial, technological, or intellectual) prior to operating their QC system. For example, a firm may need to invest in an IT system or train individuals having QC roles or responsibilities. Several commenters identified significant implementation costs and some commenters called for an extended implementation period due to these costs. For example, one commenter suggested that extensive efforts and significant investments in personnel and technology could be needed to implement the proposed requirements successfully. These implementation costs would be significantly reduced to the extent that firms would have already implemented the proposed requirements due to the actions of other standard setters or other developments. Furthermore, we expect the design and implementation costs would be largely fixed in nature and would decline significantly over time.

Firms may also incur new operating costs, at the firm level and the engagement level. At the firm level, firms may require additional resources to administer new or revised quality responses after they are implemented, execute the annual risk assessment, perform the annual evaluation of the QC system, and report the results of the evaluation to the PCAOB. Several commenters identified significant operating costs. For example, one firm noted that ongoing monitoring activities, such as testing operating effectiveness of quality controls, would be costly

to maintain. One commenter suggested that resource costs would extend beyond the assurance practice into other departments (e.g., HR and finance). At the engagement level, engagement team time may be required to execute new or revised quality responses. For example, an engagement team may carry out procedures regarding continuance of the firm's relationship with the client served by that engagement team. These operating costs would be significantly reduced to the extent that firms would already be committing resources to these activities due to the actions of other standard setters or other developments.

The direct costs would likely vary depending on the size of the firm and the nature of its audit practice. Larger firms that already have extensive QC systems in place may benefit from economies of scale or scope when incorporating the new requirements into their existing systems. They would also be able to distribute initial implementation costs over a larger number of engagements. On the other hand, it may also be difficult for firms with more complex clients and diverse client portfolios—characteristics of larger firms—to implement effective QC systems.

Several commenters suggested that smaller firms may be especially affected by new QC requirements, including requirements incremental or alternative to ISQM 1. Relatedly, research also finds that implementation and operating costs of internal control frameworks precipitated by Sarbanes-Oxley are proportionally greater for smaller companies.<sup>391</sup> To the extent that smaller firms would be disproportionately impacted, the scalable nature of the proposed QC standard, described in greater detail in Section III.C above, should help to reduce their costs.

In addition to the direct costs to auditors to comply with the proposed requirements, indirect costs may also arise. To the extent that compliance with the proposed requirements improves compliance with applicable professional and legal requirements at the engagement level, costs may increase for the affected engagements. For example, in bringing their work into compliance with PCAOB auditing standards, some engagement teams may gather additional or more persuasive audit evidence and prepare more documentation than they otherwise would have. However, firms should be incurring these costs already, and we believe that such costs are justified by the benefit of improved compliance.

Audited companies may also incur indirect costs related to the proposed requirements. For example, one commenter suggested that costs associated with a new QC standard would likely increase the overall costs of audit services and one commenter raised concerns that internal firm changes in response to a proposed new standard would impact financial statement preparers. Firms may pass on part of any increased costs they incur at the firm or engagement level by raising the fees they charge their clients. In addition, to the extent that the proposed requirements improve compliance with applicable professional and legal

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<sup>391</sup> See, e.g., John C. Coates and Suraj Srinivasan, *SOX after ten years: A multidisciplinary review*, Accounting Horizons 28.3 (2014), 627-671.

requirements, some audited companies could face additional costs to respond to their auditors' requests for additional or more extensive audit evidence. Audited companies may incur other costs due to changes in audit firm QC policies and procedures. For example, if the proposed QC standard results in changes to firms' client acceptance and continuance practices, firms may require greater fees or refuse to accept or retain high-risk clients. These indirect costs would be significantly reduced to the extent that firms would have already implemented the proposed requirements due to the actions of other standard setters or other developments.

#### **b. Costs of key provisions**

Scaled-applicability firms would incur the design costs discussed above. Should a scaled-applicability firm ever become subject to the implementation and operation requirements, the firm would then incur the implementation and operation costs discussed above. As with other registered firms, the costs to scaled-applicability firms would be significantly less to the extent they would already be complying with ISQM 1 or SQMS 1. Furthermore, scaled-applicability firms may choose to avoid the design costs by withdrawing from PCAOB registration given that they are not required to be registered.

We believe the proposed in-process monitoring requirement may contribute to direct and indirect costs discussed above such as (1) developing documentation, (2) providing training, (3) gathering additional audit evidence, (4) increased audit fees, and (5) other potential indirect costs such as the time required of issuers to provide their auditor with additional or more extensive audit evidence.

We believe there could be costs to design, implement, and operate the proposed oversight function. For example, firms that would be required to incorporate into their governance structure the proposed oversight function may incur a cost when retaining appropriate individuals from outside of the firm.<sup>392</sup> To help address these cost concerns, the proposed requirement would allow firms to implement an oversight function into their QC system which would be suitable for their circumstances. Costs, as well as the associated benefits, could be attenuated for U.S. GNFs by the fact that all of the U.S. GNFs indicate, as of the 2020 inspection cycle, that they already have a governance structure that includes a non-employee.

We believe the proposed requirement to report the annual QC system evaluation to the PCAOB would entail an additional annual cost to firms to prepare the annual report. However, since firms would already be required to perform and document the evaluation, any additional

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<sup>392</sup> According to Spencer Stuart, the average compensation per non-employee director was \$312,279 in 2021. See 2021 U.S. Spencer Stuart Board Index (2021), available at <https://www.spencerstuart.com/research-and-insight/us-board-index> (analyzing 493 DEF14A proxy statements filed by S&P 500 companies with the SEC between May 28, 2020 and May 13, 2021).

costs associated with preparing Form QC should be minimal. The proposed requirement may also result in some increased litigation risk to the extent that information reported to the PCAOB would not be subject to privilege under Section 105(b)(5) of Sarbanes-Oxley, and to the extent that reporting of this information to a third-party (i.e., the PCAOB) may vitiate other privileges that otherwise could have been used to protect the information from compelled disclosure in third-party actions.

The certification requirement may not impose a significant direct cost on firms. However, to the extent that firms choose to implement a more robust internal compliance infrastructure (e.g., by requiring sub-certifications from personnel with direct responsibility for certain functions), those costs could also be attributable to the proposed certification requirement. Moreover, firms may be exposed to litigation costs because the certifications in Form QC are not subject to privilege under Section 105(b)(5) of Sarbanes-Oxley, meaning that third parties may be able to compel production of the certifications from either the firm or the PCAOB, and the certifications may have an impact in third-party litigation. We believe, however, that the internal compliance exercise, and even potentially the threat of third-party litigation, can reinforce the importance of the firm's QC system within the firm, which in turn can help produce the benefits we expect this provision will generate.

The proposed amendments to AS 2901, *Consideration of Omitted Procedures After the Report Date*, and related proposed amendments to AT 1 No. 1 and AT No. 2 would contribute to the engagement-level costs discussed above to the extent auditors would perform additional procedures to obtain sufficient appropriate evidence or take additional action to prevent future reliance on insufficiently supported audit opinions (or review reports in the case of review engagements) that are being relied on. The proposed requirement to extend the scope of AS 2901 to include the ICFR audit within its scope would be particularly impactful because the audit of internal control over financial reporting is both resource-intensive<sup>393</sup> and a common and recurring area of deficiency.<sup>394</sup>

We believe the proposal to refine, integrate into the proposed QC standard, and extend to all firms the SECPS member requirements currently required under PCAOB Rule 3400T would increase development, implementation, and operation costs for firms not already subject to these requirements under PCAOB Rule 3400T. However, we believe the costs should be minimal because, based on our oversight activities, we believe these firms already have in place policies and procedures related to compliance with SEC and PCAOB independence rules.

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<sup>393</sup> See, e.g., U.S. Securities and Exchange Commission Office of Economic Analysis, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements* (Sept. 2009), at Table 8 (reporting that roughly one-third of total audit fees may be attributable to the ICFR audit).

<sup>394</sup> See, e.g., *Spotlight Staff Update and Preview of 2020 Inspection Observations* (Oct. 2021).

## Questions

87. Does our analysis appropriately capture the potential costs of the proposal? If not, please explain.
88. Are there additional potential costs that should be considered? If so, what are they?
89. Are there additional academic studies or data related to the potential benefits and costs of the proposed requirements? If so, what are they?

### 3. Unintended consequences

The proposed requirements could give rise to unintended consequences. Overall, however, we believe any potential unintended consequences would be substantially mitigated by other factors.

Some firms may require significant staff resources to implement the proposed requirements. To meet this demand, firms may transfer personnel from engagement-level roles to QC roles. This could create a risk that engagements are insufficiently staffed. Alternatively, some firms may assign more junior staff to QC roles or to new openings on engagements. This could create a risk that QC system or engagement personnel lack sufficient training or experience. The proposed QC standard includes quality objectives that could mitigate these risks. For example, firms would be required to establish quality objectives that individuals who are assigned to perform engagements or perform QC system activities have the competence, objectivity, authority (in the case of activities within the QC system), and time to perform their responsibilities in accordance with applicable professional and legal requirements and the firm's policies and procedures.<sup>395</sup> To meet the increased demand for staff resources, some firms may choose to hire additional experienced staff. It is possible that the labor demand shock could result in increased labor costs and potentially higher audit fees.<sup>396</sup> The scalability provisions of the proposed standard, discussed in Section III.C above, could help mitigate this risk.

The proposed requirements could also cause firms to exit the public company audit market or deter other firms from future entry. Entry deterrence would be exacerbated by the fact that being registered with the PCAOB would subject firms to certain QC requirements even if they do not perform engagements. The presence of fewer firms could reduce competition in the public company audit market. Confirming the widely held view that audit firms compete on

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<sup>395</sup> See proposed QC 1000.44c. and e.

<sup>396</sup> There are some indications that retention and recruitment of staff is currently a challenge for audit firms. See, e.g., Persellin, et al., *Auditor perceptions* 95-117; AICPA Private Companies Practice Section, *2021 PCPS CPA Top Issues Survey*.

price, some research suggests that reduced competition is indeed associated with higher audit fees.<sup>397</sup> However, any exit would likely be limited to firms with small market shares and to the smaller issuer or broker-dealer audit markets, which are highly competitive and would likely remain so. Moreover, some research suggests that reduced competition may have a positive impact on audit quality because it curtails issuers' opportunity to opinion shop.<sup>398</sup> Compounding this effect, the proposed requirements may further deter opinion shopping as a basis for competition to the extent it would improve auditors' compliance with professional standards.

It is possible that, despite the proposed requirements, firms may not significantly improve compliance with applicable professional and legal requirements when performing their engagements. For example, personnel assigned to QC roles may adopt a perfunctory, "check the box" attitude toward compliance. The risk assessment and monitoring and remediation requirements, which require personnel assigned to QC roles to think proactively about the reasonable assurance objective, could help to mitigate this risk. As another example, engagement partners may overestimate the ability of their firm's QC system to support achievement of the reasonable assurance objective and relax their efforts to self-monitor or monitor others. While the proposed QC standard centralizes responsibility for QC to a degree, other proposed and existing requirements could mitigate this risk. For example, individual responsibility features prominently in the proposed QC standard and PCAOB auditing standards emphasize the responsibility of the engagement partner for the engagement and its performance.<sup>399</sup>

Research on other quality management and enterprise risk management systems suggests other potential unintended consequences. For example, research on ISO 9000 adoption indicates that it may reduce staff morale, stifle innovation, and require excessive levels of documentation.<sup>400</sup> The principles-based nature and scalability of the proposed QC

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<sup>397</sup> See, e.g., Joshua L. Gunn, Brett S. Kawada, and Paul N. Michas, *Audit market concentration, audit fees, and audit quality: A cross-country analysis of complex audit clients*, *Journal of Accounting and Public Policy* 38.6 (2019), 1-23.

<sup>398</sup> See, e.g., Nathan J. Newton, Julie S. Persellin, Dechun Wang, and Michael S. Wilkins, *Internal control opinion shopping and audit market competition*, *The Accounting Review* 91.2 (2016), 603-623; Nathan J. Newton, Dechun Wang, and Michael S. Wilkins, *Does a lack of choice lead to lower quality? Evidence from auditor competition and client restatements*, *Auditing: A Journal of Practice & Theory* 32.3 (2013), 31-67.

<sup>399</sup> See, e.g., proposed QC 1000.42a.(1); AS 1201.03.

<sup>400</sup> See, e.g., John Seddon, *Ten arguments against ISO 9000*, *Managing Service Quality: An International Journal* 7.4 (1997), 162-168; Bozena Poksinska, Jörgen AE Eklund, and Jens Jörn Dahlgaard, *ISO 9001:2000 in small organisations Lost opportunities, benefits and influencing factors*, *International Journal of Quality & Reliability Management* 23.5 (2006), 490-512.

standard should help to mitigate these concerns by providing firms the ability to design and implement policies and procedures to support achievement of the reasonable assurance objective based on their facts and circumstances.

While the unintended consequences discussion has so far focused exclusively on negative potential outcomes, the proposed requirements could result in unintended positive outcomes as well. For example, because firms' QC systems would likely operate over all of their engagements, including those that are not subject to PCAOB standards, the proposed requirements could improve compliance on those engagements as well.

### Question

90. Are there other potential unintended consequences of the proposal that we have not identified? If so, what are they?

### D. Alternatives Considered

During the development of the proposed requirements, we considered a number of alternative approaches to address the need described in Section VI.B. above. This section explains: (1) why standard setting is preferable to other policy-making approaches, such as providing interpretive guidance or enhancing inspection or enforcement efforts; (2) why the chosen standard-setting approach is preferable to other standard-setting approaches; and (3) key policy choices made in determining the details of the proposed standard-setting approach.

#### 1. Why standard setting is preferable to another approach

As potential alternatives to standard setting, we considered whether interpretive guidance or greater focus on inspections or enforcement could better address the need described in Section VI.B. above.

Interpretive guidance assists firms in the implementation of existing PCAOB standards and rules and can advance audit quality by establishing a common understanding of a firm's obligations under PCAOB standards and rules. For example, interpretive guidance may address, among other things, specific, common audit deficiencies identified during PCAOB inspections and the applicable requirements under PCAOB standards and rules. By contrast, as discussed in Section VI.B above, some firms' QC systems appear to not be providing reasonable assurance of compliance generally. Moreover, current PCAOB QC standards were developed years ago in a very different audit environment and have not been updated to reflect the risk-based, proactive approach to QC that we believe would be most effective. Therefore, we believe revisions to the current PCAOB QC standards are needed to require firms to make the necessary enhancements to their QC systems to help drive compliance with professional standards.

While we will continue to address firms' compliance with PCAOB standards and rules through inspection and enforcement activities, QC standard setting provides certain unique benefits. Firms' QC systems operate over all aspects of all issuer audits and broker-dealer engagements, whereas PCAOB inspections assess compliance with only certain aspects of the issuer audits and broker-dealer engagements selected for review. In addition, inspection and enforcement efforts take place after the engagement has occurred and after investors and other financial statement users have potentially suffered harm. Therefore, greater focus on inspecting and enforcing compliance with PCAOB standards and rules may not be as effective as updating the QC standards and amending other related standards.

## **2. Why the chosen standard-setting approach is preferable to other standard-setting approaches**

The proposed QC standard would share the same basic structure as ISQM 1 and SQMS 1. We also considered basing the proposed QC standard on an existing quality management framework, such as COSO or ISO 9001, or developing our own risk-based approach.<sup>401</sup> The essential features of existing quality management frameworks are broadly similar to ISQM 1 and SQMS 1. For example, existing major quality management frameworks typically are risk-based and focus on monitoring and remediating deficiencies. However, ISQM 1 and SQMS 1 have the further advantage of being specifically tailored to audit firms. Furthermore, an original risk-based approach would likely include the same essential features as ISQM 1 and SQMS 1. Overall, we believe that the benefits of basing the proposed QC standard on an existing quality management framework or an original PCAOB risk-based approach (e.g., improved compliance with applicable professional and legal requirements) would be similar to the benefits of using a structure similar to ISQM 1 and SQMS 1.

Basing the proposed QC standard on another quality management framework or an original PCAOB risk-based approach would likely be significantly more costly. As highlighted in Section VI.A.5 above, we expect that many firms will become familiar with ISQM 1 or SQMS 1 and make significant investments into their QC systems to comply with those requirements. Firms may be less familiar with other quality management frameworks than they are with ISQM 1 and SQMS 1. Basing the proposed QC standard on another quality management framework or an original PCAOB risk-based approach therefore would likely require significant additional effort by firms to understand and apply the standard. Some firms may be required to employ or engage persons with the necessary expertise in the particular quality framework to facilitate appropriate implementation. While the largest firms may employ consultants with this expertise, smaller firms may not, and acquiring or engaging the necessary consultants could be costly. In addition, basing the proposed QC standard on an existing framework or an original PCAOB risk-based approach may introduce a significant element of regulatory complexity,

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<sup>401</sup> Several commenters called on the PCAOB to carefully consider other quality management frameworks.

which could both increase cost and detract from audit quality for firms that would be required to comply with ISQM 1 or SQMS 1.

### **3. Key policy choices**

In this section, we discuss several additional provisions which we have preliminarily decided against. These provisions relate to applicability, in-process monitoring activities, firm governance structure, reporting the annual QC system evaluation, self-assessment monitoring, and public reporting.

#### **a. Applicability**

Section III.C.1 above discusses the distinction between scaled applicability and full applicability. We considered requiring all firms to design, implement, and operate a QC system that meets the proposed requirements only upon being required to comply with applicable professional and legal requirements with respect to a firm engagement. This approach would reduce the costs of the proposal to firms not performing engagements by allowing them to defer the costs of designing their QC system. However, scaled-applicability firms may reduce their costs under the proposed approach by withdrawing from PCAOB registration. Furthermore, we believe any reduced costs would not justify the risk that firms would be unprepared to accept and perform engagements in compliance with applicable professional and legal requirements.

#### **b. In-process monitoring activities**

Section IV.K.1.c.ii above discusses in-process monitoring activities. We considered proposing to extend the requirement to monitor in-process engagements to all firms but preliminarily have decided to limit the requirement to firms that issue audit reports with respect to more than 100 issuers. We believe that differentiating a firm's obligation based on the number of issuer clients may be appropriate because, in our view, firms with larger, more complex audit practices may generally be subject to quality risks for which in-process monitoring would be an appropriate quality response. We also understand through our oversight activities that the majority of smaller firms do not perform in-process monitoring activities and may lack the resources to do so. Therefore, to balance these concerns, the proposed QC standard would include a "should consider" requirement to provide sufficient scalability for firms that issue audit reports with respect to 100 or fewer issuers.

#### **c. Firm governance structure**

Section IV.E.1.b above discusses specified quality responses related to governance and leadership. We considered proposing to extend to all firms the requirement to incorporate into their governance structure an oversight function for the audit practice that includes at least one person who is not an employee of the firm and does not otherwise have a commercial, familial,

or other relationship with the firm that would interfere with the exercise of independent judgement with regarding to matters related to the QC system. However, in light of the potentially significant direct cost of such an oversight function which could disproportionately impact smaller firms, and reflecting an initial view that the public interest in such independent oversight would be strongest in relation to the largest firms, the requirement is proposed to apply only to firms that issued audit reports with respect to more than 100 issuers during the prior calendar year.

#### **d. Reporting the annual QC system evaluation**

Section IV.L.1.c above discusses firm reporting on the QC system evaluation. We considered obtaining the annual QC system evaluation as part of the PCAOB inspection process rather than an explicit reporting requirement. Under this alternative approach, the evaluation may be less timely, structured, and consistent and may not inform our inspection approach as effectively, especially for triennial firms. It may also diminish the beneficial incentive effect of mandatory reporting to the PCAOB. This alternative approach could eliminate or reduce the costs to firms associated with preparing a summary report of the firm's QC system evaluation. And if, under this alternative approach, the privilege protections of Section 105(b)(5) were determined to apply to some or all of the information generated by the firm pursuant to proposed QC 1000, that would diminish the discoverability of such information in litigation, thereby decreasing third-party litigation risk. However, we believe any potential cost savings would not justify the lost information value, particularly for the triennial firms. firms.

We also considered requiring firms to report to the Board on Form QC only when the firm identifies a major QC deficiency. This approach would reduce some of the variable costs associated with preparing and transmitting Form QC to the PCAOB. However, this approach would also significantly reduce the value of Form QC to the PCAOB. For example, reporting on unremediated major QC deficiencies would inform various aspects of our inspections process including focusing inspection resources on higher risk firms, engagements, and focus areas; designing the nature and extent of inspection procedures, both for QC processes and individual engagements; and making more refined data requests from the firms. This alternative approach may also diminish the beneficial incentive effect of mandatory reporting to the PCAOB.

#### **e. Self-assessment monitoring**

We considered proposing to permit individuals to perform monitoring procedures over the same areas for which they are responsible. We decided against this approach because we feel it would be inconsistent with the quality objective that individuals who are assigned to perform activities within the QC system have the objectivity to monitor their own work in accordance with applicable professional and legal requirements and the firm's policies and

procedures.<sup>402</sup> As emphasized in Section VI.B.5 above, this quality objective is important for creating accountability within the firm to achieve the reasonable assurance objective. Information gathered through PCAOB inspection activities indicates that roughly 3% of firms inspected between 2018 and 2020 performed self-assessments. This suggests that relatively few firms would be impacted by this policy choice. We considered allowing self-assessment monitoring under certain conditions to reduce costs for impacted firms but ultimately decided against it out of concern that individuals may not be able to objectively assess their own work. In these circumstances, the firm may use other participants or third-party providers to perform monitoring activities.

#### **f. Public reporting**

The concept release noted we were considering the extent to which the information in Form QC should be publicly available. Section IV.L.1.c.ii above summarizes commenters' views on public reporting about firms' QC systems and legal constraints on public disclosure that are imposed by Sarbanes-Oxley. Our preliminary view is that firm reporting on Form QC should be nonpublic. However, we are soliciting comment on whether there are other public reporting alternatives we should consider, in light of the legal constraints of Sarbanes-Oxley discussed in Section IV.L.1.c.ii, and what the costs and benefits of such public reporting could be.

#### **Question**

91. Are any alternative approaches to addressing the need for standard setting preferable to the proposed approach? If so, why?

### **VII. SPECIAL CONSIDERATIONS FOR EMERGING GROWTH COMPANIES**

Pursuant to Section 104 of the Jumpstart Our Business Startups ("JOBS") Act, rules adopted by the Board subsequent to April 5, 2012, generally do not apply to the audits of emerging growth companies ("EGCs"), as defined in Section 3(a)(80) of the Exchange Act, unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation."<sup>403</sup> As a result of the JOBS

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<sup>402</sup> See proposed QC 1000.44e.

<sup>403</sup> See Pub. L. No. 112-106 (Apr. 5, 2012). Section 103(a)(3)(C) of Sarbanes-Oxley, 15 U.S.C. § 7213(a)(3)(C), as added by 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. None of the rules and amendments we are proposing would fall within either of these two categories.

Act, the rules and related amendments to PCAOB standards that the Board adopts are generally subject to a separate determination by the SEC regarding their applicability to audits of EGCs.

To inform consideration of the application of PCAOB standards to audits of EGCs,<sup>404</sup> the staff publishes an annual white paper that provides general information about characteristics of EGCs.<sup>405</sup> As of November 15, 2020, the most recent measurement date, PCAOB staff identified 1,940 companies that had self-identified as EGCs and filed audited financial statements with the SEC, including an audit report signed by a firm in the 18 months preceding the measurement date. Of the 237 registered firms that audited EGCs, 200 firms (or 84%) audited other clients—either non-EGC issuers or registered broker-dealers—whose audits are required to be performed under PCAOB standards. Approximately 97% of EGCs were audited by these 200 firms.

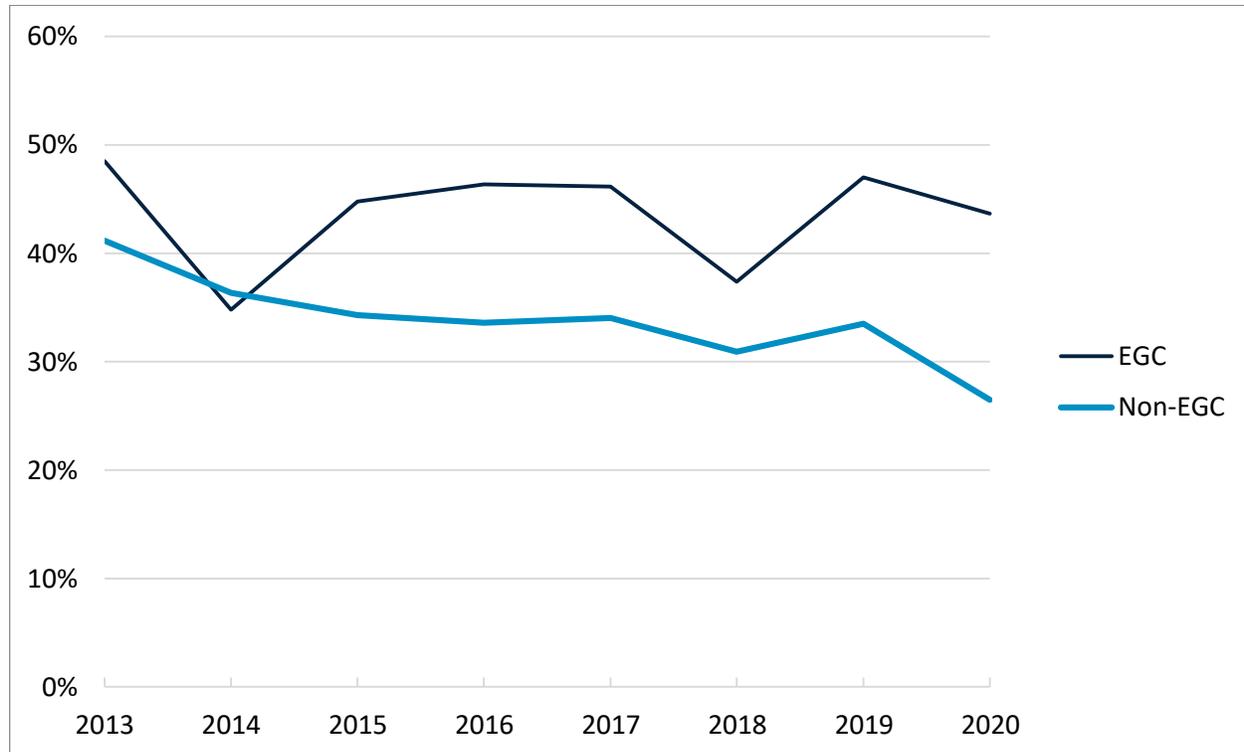
PCAOB staff also gathered information on trends in Part I.A deficiencies for the audits of EGCs between 2013 and 2020. Figure 6 presents trends in the percentage of inspected EGC and non-EGC issuer audits having at least one Part I.A deficiency. The data suggest that Part I.A deficiencies are even more common among audits of EGCs, raising questions about whether QC systems of firms that audit EGCs are effective in preventing audit deficiencies for these types of audit engagements.

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<sup>404</sup> We are providing this analysis of the impact on EGCs to assist the SEC in making any determination required under Section 104 to the extent that our proposals apply to “the audit of any emerging growth company” within the meaning of Section 104 of the JOBS Act.

<sup>405</sup> See *White Paper on Characteristics of Emerging Growth Companies and Their Audit Firms at November 15, 2020* (Jan. 24, 2022), available at <https://pcaobus.org/resources/other-research-projects>.

**Figure 6. Percentage of Inspected EGC and Non-EGC Issuer Audits Having at Least One Part I.A Deficiency (2013-2020)**



In general, any new PCAOB standards and amendments to existing standards determined not to apply to the audits of EGCs would require auditors to address differing requirements within their methodologies or policies and procedures with respect to audits of EGCs and non-EGCs, which would create the potential for confusion. This may not be practical in the context of the QC standards; while some components of the QC system (such as engagement monitoring) may enable different approaches for audits of EGCs compared to audits of other companies, other elements (for example, resources and governance and leadership) are necessarily firm-wide and cannot easily be differentiated for different types of audits. Even where differentiation is possible, maintaining separate components for EGC and non-EGC audits may add cost or lead to confusion, and could run counter to the objective of integrating QC practices into a single virtuous cycle of risk assessment, monitoring, and remediation. These QC system differentiation costs would affect at least 84% of registered firms who audit both EGC and non-EGC issuers and who, collectively, audit approximately 97% of EGCs.

The discussion of economic impacts of the proposed standard is generally applicable to the audits of EGCs. In particular, the benefits to financial reporting quality articulated in Section VI.C.1 above may be especially significant for EGCs, including improved efficiency of capital allocation, lower cost of capital, and enhanced capital formation. EGCs tend to be smaller and have a shorter SEC financial reporting history than the broader population of public companies.

Academic research suggests that, for several reasons, smaller public companies tend to exhibit greater information asymmetry between management and investors.<sup>406</sup> Accordingly, EGCs are likely to exhibit greater information asymmetry between management and investors and hence the importance of the external audit to investors in enhancing the credibility of EGC financial reporting may be more pronounced.

The proposal could impact competition in an EGC product market if the indirect costs to audited companies of the proposal disproportionately impact the EGCs relative to their competitors. EGCs may be forced to raise prices, thereby diverting market share toward their competitors. This could increase competition in markets where EGCs have a dominant market share and decrease competition in markets where EGCs have a less than dominant market share. The potential impact to competition in EGC product markets would be reduced to the extent EGC auditors will already be required to comply with ISQM 1 or SQMS 1 or otherwise would choose not to pass on incremental costs arising from the proposed requirements in the form of higher audit fees.

### Question

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

### VIII. EFFECTIVE DATE

We seek comment on the amount of time auditors would need before the proposed new quality control standard and the amendments to PCAOB standards, rules, and forms we are proposing, if adopted by the Board and approved by the SEC, become effective. In that regard, we note that ISQM 1 will take effect as of December 15, 2022, and SQMS 1 will take effect as of December 15, 2025.

We are considering an effective date of December 15 of the year after approval by the SEC. We believe that effective date would afford sufficient time for firms to implement the proposed requirements, particularly given that almost all firms will also be required to comply with broadly similar QC requirements under IAASB or AICPA standards.

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<sup>406</sup> For example, smaller public companies tend to have less analyst coverage and a greater share of insider holdings. See Raymond Chiang and P. C. Venkatesh, *Insider Holdings and Perceptions of Information Asymmetry: A Note*, Journal of Finance 43.4 (1988), 1041-1048; Ravi Bhushan, *Firm characteristics and analyst following*, Journal of Accounting and Economics 11.2-3 (1989), 255-274.

We are proposing that, if adopted, all the provisions of QC 1000 would take effect on the same day. This approach differs from that taken in ISQM 1 and SQMS 1, under which the requirements for evaluation of the QC system take effect one year later than the other provisions of the standard. Because our proposed evaluation date of November 30 builds in almost a full year delay between the effective date of the standard and the first evaluation date, we do not believe further delay would be necessary or appropriate.

## Question

93. Would the effective date as described above provide challenges for auditors? If so, what are those challenges, and how should they be addressed?

## IX. LIST OF QUESTIONS

1. Is the proposed definition of “applicable professional and legal requirements” appropriate? Are there elements that should be excluded, or other requirements that we should include? If so, what are they?
2. Is the proposed definition of “engagement” clear and appropriate? If not, why not? Should the definition be narrower (e.g., limited to engagements required to be performed under PCAOB standards) or broader? If so, how?
3. Are the proposed definitions of “firm personnel,” “other participants,” and “third-party providers” sufficiently clear and comprehensive, or is additional direction necessary? Please explain what additional direction may be necessary.
4. Is the other terminology used in QC 1000 clear and appropriate? Are there other terms that should be defined?
5. Is it appropriate for the proposed standard to require firms that have not and do not plan to perform engagements pursuant to PCAOB standards to design a QC system in accordance with QC 1000? Why or why not? Would this requirement impose disproportionate costs on small firms? Please provide data or estimates, if available, on such costs.
6. Is the proposed distinction between the obligation to design a QC system and the obligation to implement and operate a QC system appropriate? Is the proposed threshold for full applicability of QC 1000—having obligations under applicable professional and legal requirements with respect to a firm engagement—appropriate?
7. Is it clear how a firm’s responsibilities under QC 1000 may change depending on the extent of “applicable professional and legal requirements” to which the firm is subject at a particular time? Please explain what additional direction may be necessary.
8. Are there other provisions of QC 1000 that should apply to all firms? If so, which other provisions should we consider?

9. We intend the proposed standard to be scalable for all firms based on their nature and circumstances. Are there additional factors we should consider so that the proposed standard is scalable for all firms? If so, what are those factors? Should the standard be revised to make it more scalable? If so, how?
10. Is the reasonable assurance objective described in the proposed standard appropriate? If not, why not? Are there additional objectives that a QC system should achieve? If so, what are they?
11. Are the proposed requirements regarding design of the QC system appropriate? Are there other aspects of QC 1000 that should be required as part of the design of the QC system? If so, what are they?
12. Are the proposed requirements related to roles and responsibilities described in the standard clear and appropriate? If not, how should they be clarified or modified?
13. Would firms have difficulty filling the specified roles in light of the proposed requirements?
14. Are the proposed definitions of “quality risks,” “quality objectives,” and “quality responses” sufficiently clear and comprehensive? If not, why not?
15. Is the threshold of “adversely affecting” set out in the proposed definition of quality risk clear, or would more guidance and examples be helpful?
16. Should the proposed definition of “quality risks” explicitly address risks of intentional misconduct by firm personnel and other participants? If not, please explain why. Should the definition explicitly address other risks? If so, what are the other risks?
17. In the proposed definition of “quality risks” should the threshold of “reasonable possibility of occurring” also apply to all risks, including risks of intentional misconduct by firm personnel and other participants? If so, why?
18. Are the proposed requirements for the firm’s risk assessment process appropriate? Are changes to the requirements necessary for this process? If so, what changes?
19. Are the proposed requirements sufficient to prompt firms to appropriately identify, assess, and respond to quality risks, or is supplemental direction needed? If supplemental direction is needed, what would assist firms in identifying, assessing, and responding to quality risks?
20. Are the specific examples included in Appendix B helpful in assisting the firm in identifying and assessing quality risks? Should additional examples or guidance be provided? If so, what additional examples or guidance would be helpful?

21. Are the proposed quality objectives for governance and leadership appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?
22. For the proposed specified quality response related to the firm's governance structure, is the threshold (firms that issued audit reports with respect to more than 100 issuers during the prior calendar year) appropriate? If not, what is an appropriate threshold?
23. Is the proposed specified quality response to incorporate an oversight function for the audit practice for firms that issue auditor reports with respect to more than 100 issuers appropriate? If not, why not?
24. Is the proposed specified quality response related to the firm's policies and procedures on receiving and investigating complaints and allegations appropriate? Are there any other specified quality responses in this area that we should consider, and if so, what are they?
25. Are there any other specified quality responses for the governance and leadership component that we should consider? If so, what are they?
26. Are the proposed quality objectives for ethics and independence requirements appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?
27. Are the proposed specified quality responses for ethics and independence requirements appropriate? If not, what changes to the specified quality responses are necessary for this component?
28. Is the proposed specified quality response to have an automated process for identifying direct or material indirect financial interests appropriate? If not, why not? Is the proposed threshold (firms that issued audit reports with respect to more than 100 issuers during the prior calendar year) appropriate? If not, why not?
29. Is the proposed specified quality response related to communication of changes to the list of restricted entities at least monthly (and more frequently, if appropriate) to firm personnel and others performing work on behalf of the firm who are subject to independence requirements appropriate? Could communication to a more limited group accomplish the goal of alerting all individuals whose actions and relationships are relevant to independence? If so, to whom should changes be communicated?
30. In addition to the annual written independence certification, should the proposed standard require an annual written certification regarding familiarity and compliance with ethics requirements and the firm's ethics policies and procedures? Why or why not? Should firms be required or encouraged to adopt firm-wide codes of ethics or similar protocols? Why

or why not? Are there other specific policies that QC 1000 should require or encourage to promote ethical behavior?

31. Are the proposed quality objectives for acceptance and continuance of client relationships and specific engagements appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?
32. Are the proposed specified quality responses for acceptance and continuance of client relationships and specific engagements appropriate? If not, what changes to the specified quality responses are necessary for this component?
33. Are the proposed quality objectives for engagement performance appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?
34. Should we include specified quality responses for the engagement performance component? If so, what should they be?
35. We are proposing to eliminate the current Appendix K requirement and rely exclusively on a risk-based approach. Should the standard include specified quality responses explicitly directed to non-U.S. firms that audit issuers? If so, what are they?
36. Are the proposed quality objectives for resources appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?
37. Does the proposed quality objective and specified quality response related to technological resources provide sufficient direction to enable the appropriate use of emerging technologies? If not, what additional direction is necessary?
38. Are the proposed specified quality responses for resources appropriate? If not, what changes to the specified quality responses are necessary for this component?
39. Should the proposed standard include a specified quality response that would require the use of technological resources by the firm to respond to the risks related to the use of certain technology by the firm's clients? If yes, what should the requirement be?
40. Are the proposed quality objectives for information and communication appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?
41. Is the proposed quality objective addressing the firm's external communications about firm-level and engagement-level information appropriate? If not, what changes to the quality objective are necessary?
42. Are the proposed quality objective and specified quality response addressing information and communication related to other participants appropriate? If not, why not, and what changes are necessary?

43. Are there legal or regulatory concerns regarding other participant firms sharing the most recent evaluation of their QC system and a brief overview of remedial actions taken and to be taken? If so, please specify.
44. Are the proposed specified quality responses for information and communication appropriate? If not, what changes to the specified quality responses are necessary for this component?
45. Are the proposed requirements for the monitoring and remediation process appropriate? Are changes to the requirements necessary for this process? If so, what changes should be made and why?
46. Is the proposed requirement to inspect engagements for each engagement partner on a cyclical basis appropriate? If not, why not?
47. Is it appropriate to require monitoring of in-process engagements by firms that issue audit reports with respect to more than 100 issuers during a calendar year? If not, is there a more appropriate threshold?
48. Are the purposes of in-process monitoring (as proposed within this standard) clear and appropriate, including how in-process monitoring differs from the requirements of engagement quality reviews under AS 1220? If not, what additional direction is needed?
49. Is it appropriate to require firms to consider performing monitoring activities on work they perform on other firms' engagements? If not, why not?
50. Are the proposed factors for firms to take into account when determining the nature, timing, and extent of engagement monitoring activities, including which engagements to select, appropriate? If not, what other factors should be specified?
51. Are the proposed factors for firms to take into account when determining the nature, timing, and extent of QC system-level monitoring activities appropriate? If not, what other factors should be specified?
52. Are the proposed requirements for firms that belong to a network that performs monitoring activities appropriate? If not, what changes should be made?
53. Are the proposed definitions for "engagement deficiency," "QC finding," and "QC deficiency" sufficiently clear and appropriate? If not, what changes should be made and why?
54. What, if any, additional direction is needed regarding:
- Evaluating information to determine whether QC findings exist;
  - Evaluating QC findings to determine whether QC deficiencies exist; or
  - Responding to engagement and QC deficiencies?

55. Should firm personnel be allowed to inspect engagements or QC activities in which they are involved? If so, please explain why and provide examples of mechanisms that could reduce to an appropriate level the risk that noncompliance with PCAOB standards or the firm's policies and procedures would not be detected.
56. Are the proposed requirements related to monitoring and remediation sufficiently scalable for smaller firms? Are there aspects of the proposed requirements that could be further scaled?
57. Is November 30 an appropriate evaluation date for firms to conclude on the effectiveness of the QC system? Is there another specific date that would be more appropriate and if so, what date? Should firms be permitted to choose their own evaluation date?
58. Is the proposed definition of "major QC deficiency" clear and appropriate? If not, what changes should be made and why?
59. Is it appropriate to include in the proposed definition circumstances when a major QC deficiency is presumed to exist? Are the circumstances described in the proposed definition appropriate? Should there be other circumstances that give rise to such a presumption? If so, what are they?
60. Are the proposed factors for determining whether an unremediated QC deficiency is a major QC deficiency appropriate? If not, what other factors should be specified?
61. Should firms be required to report on the evaluation of the QC system to the PCAOB? If not, why not?
62. Should we require individual certifications of the evaluation of the QC system? Is the language in Appendix 2 regarding the certifications appropriate? If not, why not?
63. Is the proposed date for reporting on the evaluation of the QC system (January 15) appropriate? Is there another specific date that would be more appropriate and if so, what date? Is 45 days after the evaluation date an appropriate reporting date?
64. Rather than reporting on Form QC, should firms report on the evaluation of the QC system, as of March 31 on a non-public portion of Form 2, which is due on June 30?
65. Is the information required on proposed Form QC in Appendix 2 appropriate? Why or why not?
66. Are proposed Rule 2203A, *Report on the Evaluation of the Firm's System of Quality Control*, and the proposed Form QC instructions included in Appendix 2, clear and appropriate? If not, why not?
67. Are there any non-U.S. laws that would prohibit reporting the information required about the firm's QC system to the PCAOB on Form QC?

68. Some of the PCAOB's reporting forms are permitted to be filed in XML format. Should we permit proposed Form QC to be filed in XML or another machine-readable format? Why or why not?
69. In light of the legal constraints of Sarbanes-Oxley with respect to public reporting regarding QC matters, are there other public reporting alternatives that should be considered? What would be the potential costs and benefits of such alternatives?
70. Are the proposed amendments to AS 1301 that require the auditor to communicate to the audit committee about the firm's most recent annual evaluation of its QC system appropriate? If not, why not?
71. Are the proposed documentation requirements appropriate? If not, what changes should be made?
72. Is the "experienced auditor QC threshold" set out in the in the proposed documentation requirement appropriate? If not, what threshold is appropriate?
73. Are there additional specific matters that the firm should be required to document about its QC system? If so, what are they?
74. Is the proposal to expand the scope of AS 2901 to include engagement deficiencies on ICFR audits appropriate? If not, why not?
75. Is it appropriate for remedial action to be required for all identified engagement deficiencies, not just in situations where the auditor's opinion may be unsupported? If not, why not?
76. Is the proposal to rescind ET 102 and replace it with EI 1000 appropriate in light of the changes proposed in QC 1000 and developments since 2003? If not, why not?
77. Are the terms used in EI 1000 clear? Should additional terms be defined or additional guidance provided?
78. Is the proposal to amend ET 191, including the proposed rescission of certain paragraphs, appropriate? Should any of the proposed interpretations be retained in our standards?
79. Are the proposed amendments to other PCAOB standards and rules appropriate? If not, why not? Are there additional amendments to other PCAOB standards or rules that the Board should consider?
80. Are the proposed amendments to Form 1 and Form 2 in Appendix 5 appropriate? If not, why not?
81. Are there additional academic studies or data related to the baseline for measuring the potential impacts of the proposed requirements? If so, what are they?

82. Are there additional academic studies or data available related to the resources employed by NAFs or foreign affiliates of GNFs in the design, implementation, and operation of their QC systems? If so, what are they?
83. Are there additional academic studies or data available that could help us approximate the number of firms that will be implementing ISQM 1 or SQMS 1? If so, what are they?
84. Should we consider any additional academic studies or data related to the need for standard setting?
85. Does our analysis appropriately capture the potential benefits of the proposal? If not, please explain.
86. Are there additional potential benefits that should be considered? If so, what are they?
87. Does our analysis appropriately capture the potential costs of the proposal? If not, please explain.
88. Are there additional potential costs that should be considered? If so, what are they?
89. Are there additional academic studies or data related to the potential benefits and costs of the proposed requirements? If so, what are they?
90. Are there other potential unintended consequences of the proposal that we have not identified? If so, what are they?
91. Are any alternative approaches to addressing the need for standard setting preferable to the proposed approach? If so, why?
92. The Board requests comment generally on the analysis of the impacts of the proposal on EGCs. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made so that the proposal would be appropriate for audits of EGCs? What impact would the proposal likely have on EGCs, and how would this affect efficiency, competition, and capital formation?
93. Would the effective date as described above provide challenges for auditors? If so, what are those challenges, and how should they be addressed?

## X. OPPORTUNITY FOR PUBLIC COMMENT

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

Comments should be sent by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's website at [www.pcaobus.org](http://www.pcaobus.org). Comments may also be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. All comments should refer to PCAOB Rulemaking Docket Matter No. 046 in the subject or reference line and should be received by the Board no later than February 1, 2023.

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

\* \* \*

On the 18th day of November, in the year 2022, 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

November 18, 2022

## APPENDIX 1 – PROPOSED QUALITY CONTROL STANDARD (QC 1000)

### QC 1000, A Firm's System of Quality Control

#### Introduction

.01 This standard sets forth the requirements for a registered public accounting firm (“firm”) with respect to the design, implementation, and operation of a quality control (“QC”) system. This standard establishes a risk-based approach to the firm’s QC system such that the firm proactively manages the quality of *engagements*<sup>1</sup> it performs. This risk-based approach includes establishing *quality objectives*, identifying and assessing *quality risks* to the achievement of the *quality objectives*, designing and implementing *quality responses* to address the *quality risks*, and monitoring the firm’s QC system.

.02 A QC system, as described by this standard, consists of components that are present, function, and operate together, not exclusively in a linear manner, enabling the consistent performance of *engagements* in accordance with *applicable professional and legal requirements*. A QC system is a continual and iterative process that is responsive to changes in the nature and circumstances of the firm and its *engagements* and to relevant information that the firm gathers through its monitoring activities and from other sources. The QC system reflects and reinforces the firm’s role in protecting the interests of investors and furthering the public interest in the preparation of informative, accurate, and independent audit reports.

.03 This standard describes the following eight integrated components of a firm’s QC system:

- a. The firm’s risk assessment process;
- b. Governance and leadership;
- c. Ethics and independence;
- d. Acceptance and continuance of client relationships and specific *engagements*;
- e. *Engagement* performance;
- f. Resources;
- g. Information and communication; and

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<sup>1</sup> Terms defined in Appendix A, *Definitions*, are italicized throughout the standard.

h. The monitoring and remediation process.

Note: The components of the QC system interact with each other in a variety of ways. For example, the firm’s risk assessment process applies to the components for which *quality objectives* are established. The monitoring and remediation process applies to all of the components of the QC system, including the monitoring and remediation component itself.

.04 In addition to the requirements relating to the components of the QC system, this standard includes requirements related to:

- a. Roles and responsibilities (see paragraphs .11-.17);
- b. Evaluation of and reporting on the QC system (see paragraphs .77-.80); and
- c. Documentation of the QC system (see paragraphs .81-.86).

### The Firm’s QC System

.05 An effective QC system provides a firm with reasonable assurance that:

- a. The firm, *firm personnel*, and *other participants*:
  - (1) Conduct *engagements* in accordance with *applicable professional and legal requirements*; and
  - (2) Fulfill their other responsibilities that are part of or subject to the firm’s QC system in accordance with *applicable professional and legal requirements*; and
- b. *Engagement reports*<sup>2</sup> issued by the firm are in accordance with *applicable professional and legal requirements*

(hereinafter referred to as the “reasonable assurance objective”).

Note: Reasonable assurance is obtained when a firm’s QC system reduces to an appropriately low level the risk that the objectives set forth in a. and b. are not achieved. Although not absolute assurance, reasonable assurance is a high level of assurance.

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<sup>2</sup> "Engagement reports" refers to reports issued in connection with *engagements* (e.g., audit, attest, examination, or review).

.06 A firm must design a QC system that complies with this standard. To design such a QC system, the firm must:

- a. Assign QC-related roles and responsibilities (*see* paragraphs .11-.17);
- b. Establish *quality objectives*, annually identify and assess *quality risks* to those objectives, and design *quality responses* to those risks (*see* paragraphs .18-.57);
- c. Design a monitoring and remediation process (*see* paragraphs .58-.76); and
- d. Document the design of the QC system (*see* paragraphs .81-.86).

.07 The requirement to implement and operate the QC system applies as follows:

- a. A firm must implement and operate an effective QC system at all times when the firm is required to comply with *applicable professional and legal requirements* with respect to any of the firm's *engagements*<sup>3</sup> and thereafter through the following November 30.<sup>4</sup>
- b. During the time the firm's QC system is required to be operating effectively, the firm's QC system must operate over any audit, attestation, review, or other work performed under PCAOB standards by the firm, regardless of the level of the firm's participation in such work (i.e., even if the firm plays less than a substantial role).<sup>5</sup>
- c. A firm that is required to implement and operate its QC system is also required to annually evaluate its QC system as of November 30 and report on that evaluation (*see* paragraphs .77-.80).
- d. For any time that a firm is not required to implement and operate an effective QC system, this standard will apply to the firm only in regard to the design of the QC system (based on the *quality risks* the firm likely would face if it were to perform engagements) as provided in paragraph .06.

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<sup>3</sup> With respect to firm responsibilities subsequent to the issuance of an audit report, see, for example, AS 2901, *Responding to Engagement Deficiencies After Issuance of the Auditor's Report* [as proposed to be amended]; AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*; AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*.

<sup>4</sup> See paragraph .77 (requiring evaluation of the effectiveness of the QC system as of November 30).

<sup>5</sup> See PCAOB Rule 1001(p)(ii).

Note: Any obligations under QC 1000 that exist at the time a firm is no longer required to implement and operate the QC system, such as obligations to evaluate and report on the QC system for previous periods, will continue.

- .08 In applying a risk-based approach to its QC system, the firm must:
- a. Design, implement, and operate a risk assessment process, including:
    - (1) Establishing *quality objectives* necessary to achieve the reasonable assurance objective;
    - (2) Identifying and assessing *quality risks* to the achievement of the *quality objectives*; and
    - (3) Designing and implementing *quality responses* to address the *quality risks*;
  - b. Design, implement, and operate a monitoring and remediation process; and
  - c. Evaluate the effectiveness of the QC system and report on that evaluation.

.09 In applying a risk-based approach to the firm's QC system, the firm must take into account the nature and circumstances of the firm, its *engagements*, and other relevant information. Accordingly, the firm should tailor its QC system to the firm's specific facts and circumstances (e.g., the size and complexity of the firm, the types and variety of *engagements* it performs, the types of companies for which it performs *engagements*, and whether it is a member of a network and, if so, the nature and extent of the relationship between the firm and the network).

Note: Networks may be structured in a variety of ways and could include arrangements between firms for the purpose of sharing knowledge; developing and implementing consistent policies, tools, and methodologies; conducting multi-location *engagements*; or executing other types of business or service matters. Networks may include both registered and non-registered accounting firms.

.10 All *firm personnel* and *other participants* involved in the design, implementation, and operation of the QC system must exercise due professional care. Due professional care requires, among other things, the exercise of professional skepticism when obtaining and evaluating information. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the relevant information. *Firm personnel* and *other participants* must use the knowledge, skill, and ability called for by *applicable professional and legal*

*requirements* to diligently perform, in good faith and with integrity, the obtaining and objective evaluation of information.<sup>6</sup>

## Roles and Responsibilities

.11 The firm’s principal executive officer (i.e., the highest-ranking executive, regardless of formal title) is ultimately responsible and accountable for the QC system as a whole.

Note: If a firm has co-principal executive officers, the references to “the individual assigned ultimate responsibility and accountability for the QC system as a whole” apply to each of the co-principal executive officers and each of them is ultimately responsible and accountable for the QC system as a whole.

.12 The firm must assign other roles and responsibilities with respect to the QC system to *firm personnel* who have the experience, competence, authority, and time to enable them to carry out their assigned responsibilities.<sup>7</sup> Such roles should include the following:

- a. Operational responsibility and accountability for the QC system as a whole;
- b. Operational responsibility for the firm’s compliance with ethics and independence requirements;
- c. Operational responsibility for the monitoring and remediation process; and
- d. If appropriate based on the nature and circumstances of the firm, operational responsibility for other components of the QC system.

Note: Depending on the nature and circumstances of the firm (including its size and structure) and its *engagements*, the firm may assign one individual to more than one of the roles identified in paragraphs .11 and .12.

.13 The firm should establish a direct line of communication from each individual assigned operational responsibilities (*see* paragraph .12a.-d.) to the individual assigned ultimate responsibility and accountability for the QC system as a whole (*see* paragraph .11).

.14 The individual assigned ultimate responsibility and accountability for the QC system as a whole should:

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<sup>6</sup> For analogous discussions of due professional care, see AS 1015, *Due Professional Care in the Performance of Work*; paragraphs .39-.41 of AT Section 101, *Attest Engagements*.

<sup>7</sup> See Note in paragraph .44a. of this standard for a description of competence.

- a. Demonstrate a commitment to quality through the individual's actions, behaviors, and communications. This includes recognizing and reinforcing the importance of professional ethics, values, and attitudes, and establishing the expected behavior of *firm personnel* related to activities within the firm's QC system and the performance of its *engagements*.
- b. Establish or direct the establishment of structures, reporting lines, and authorities and responsibilities for the following roles:
  - (1) Operational responsibility and accountability for the QC system as a whole;
  - (2) Operational responsibility for the firm's compliance with ethics and independence requirements;
  - (3) Operational responsibility for the monitoring and remediation process; and
  - (4) If assigned, operational responsibility for other aspects of the QC system.
- c. Be accountable for the design, implementation, and operation of the firm's QC system in accordance with *applicable professional and legal requirements* and the firm's policies and procedures and for the annual evaluation of the firm's QC system required by paragraph .77.
- d. Certify the firm's report to the PCAOB on its annual evaluation of the QC system (*see* paragraph .79).

.15 The individual assigned operational responsibility and accountability for the QC system as a whole should:

- a. Supervise the design, implementation, and operation of the firm's QC system in accordance with *applicable professional and legal requirements* and the firm's policies and procedures; and
- b. Certify the firm's report to the PCAOB on its annual evaluation of the QC system (*see* paragraph .79).

.16 The individual assigned operational responsibility for the firm's compliance with ethics and independence requirements should:

- a. Supervise the design, implementation, and operation of the firm's ethics and independence component (*see* paragraphs .30-.36); and
- b. Communicate, on a timely basis, violations of ethics or independence requirements, including personal independence violations, to the individuals assigned (1)

operational responsibility for the firm’s monitoring and remediation process and (2) operational responsibility and accountability for the QC system as a whole.

.17 The individual assigned operational responsibility for the monitoring and remediation process should:

- a. Supervise the design, implementation, and operation of the firm’s monitoring and remediation process (*see* paragraphs .58-.76) and the annual evaluation of the QC system (*see* paragraphs .77-.78), including:
  - (1) The evaluation of the results of the monitoring activities;
  - (2) The evaluation of whether remedial actions are implemented as designed and operate effectively to remediate *QC deficiencies* and, if not, the taking of timely action until such *QC deficiencies* are remediated; and
  - (3) The firm’s other policies and procedures with regard to monitoring and remediation.
- b. Communicate, on a timely basis, to the individuals assigned (1) ultimate responsibility and accountability for the QC system as a whole and (2) operational responsibility and accountability for the QC system as a whole, a description of:
  - (1) Monitoring activities performed and the results of such activities, including, if applicable, monitoring activities performed by the network;
  - (2) Identified *engagement deficiencies*, *QC deficiencies*, and *major QC deficiencies*, including the nature, severity, and pervasiveness of such deficiencies; and
  - (3) Actions taken to address *engagement deficiencies*, *QC deficiencies*, and *major QC deficiencies*.

## The Firm’s Risk Assessment Process

.18 The firm’s risk assessment process provides the basis for the design, implementation, and operation of the firm’s QC system. The risk assessment process consists of establishing *quality objectives*, identifying and assessing *quality risks* to the achievement of the *quality objectives*, and designing and implementing *quality responses* to the *quality risks*.

.19 The firm must establish the *quality objectives* necessary to achieve the reasonable assurance objective. This consists of the *quality objectives* specified in this standard and any other *quality objectives* that are necessary under paragraph .08a.(1).

Note: *Quality objectives* are specified in this standard for six of the components of the QC system: governance and leadership (see paragraph .25), ethics and independence (see paragraph .31), acceptance and continuance of client relationships and specific *engagements* (see paragraph .38), *engagement* performance (see paragraph .42), resources (see paragraph .44), and information and communication (see paragraph .53).

.20 Annually, the firm must identify and assess *quality risks* to achieving each of the *quality objectives* established by the firm. The firm should:

a. Obtain an understanding of the conditions, events, and activities that may adversely affect the achievement of its *quality objectives*, which includes an understanding of the following:

(1) The nature and circumstances of the firm, including:

(a) The complexity and operating characteristics of the firm;

(b) The firm's business processes and strategic and operational decisions and actions;

(c) The characteristics and management style of leadership;

(d) The resources of the firm;

(e) The environment in which the firm operates, including *applicable professional and legal requirements*;

(f) If the firm belongs to a network, the characteristics of the network and the network's resources and services and the nature and extent of such resources and services used by the firm;

(g) If the firm uses *other participants*, the nature and extent of their involvement;

(h) If the firm participates in other firms' *engagements*, the nature and extent of the firm's participation; and

(i) If the firm uses resources or services obtained from *third-party providers*, the nature and extent of those resources or services.

(See Appendix B for specific examples.)

- (2) The nature and circumstances of the firm’s *engagements* (see Appendix B for specific examples).
- (3) Other relevant information, including information from the firm’s monitoring and remediation activities, external inspections or reviews, and other oversight activities by regulators.

Note: The firm might identify conditions, events, and activities that may adversely affect the achievement of its *quality objectives* by asking “what could go wrong?” in relation to the achievement of a given *quality objective*.

- b. Identify and assess *quality risks* based on the understanding obtained pursuant to paragraph .20a. and taking into account whether, how, and the degree to which the achievement of the *quality objectives* may be adversely affected.

Note: The assessment of *quality risks* is based on inherent risk (i.e., without regard to the effect of any related *quality responses*).

.21 The firm must design and implement *quality responses* that (1) are based on the *quality risks* and the reasons for the assessments given to the *quality risks*, and (2) reduce to an appropriately low level the risk that the *quality objective* will not be achieved.

Note: Certain components include requirements for specified *quality responses*. These specified *quality responses* are to be included in the *quality responses* designed and implemented by the firm. Specified *quality responses* may address multiple *quality risks* within multiple components but are not intended to be comprehensive and alone will not be sufficient to enable the firm to achieve all established *quality objectives* of the firm’s QC system. Depending on the *quality risk* being addressed, specified *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

### **Modifications to the Quality Objectives, Quality Risks, or Quality Responses**

.22 In addition to identifying and assessing *quality risks* annually, the firm should establish policies and procedures to monitor, identify, and assess changes to conditions, events, and activities that indicate modifications to the firm’s *quality objectives*, *quality risks*, or *quality responses* may be needed. Such policies and procedures should specify that the firm take into account, among other sources, information from the firm’s monitoring and remediation process.

.23 If the firm identifies changes to conditions, events, or activities indicating that modifications to the *quality objectives*, *quality risks*, or *quality responses* may be needed, the firm should determine what, if any, modifications are needed and make them on a timely basis.

## Governance and Leadership

.24 The governance and leadership component addresses the environment that enables the effective oversight and operation of the QC system and directs the firm’s culture, decision-making processes, organizational structure, and leadership.

### Governance and Leadership Quality Objectives

.25 The *quality objectives* established by the firm with respect to its governance and leadership should include the following:

- a. The firm’s commitment to quality is communicated and promoted by leadership to recognize and reinforce:
  - (1) The firm’s role in protecting the interests of investors and the public interest by consistently fulfilling its responsibilities under *applicable professional and legal requirements*;
  - (2) The importance of adherence to appropriate standards of conduct by *firm personnel*;<sup>8</sup>
  - (3) The importance of professional ethics, values, and attitudes; and
  - (4) The expected behavior and responsibility of *firm personnel* for quality relating to activities that are subject to *applicable professional and legal requirements*, including activities within the firm’s QC system and the firm’s performance on *engagements*.
- b. The firm clearly defines leadership’s responsibility for quality and holds leadership accountable.
- c. Leadership demonstrates a commitment to quality through its actions and behaviors.
- d. The firm’s strategic decisions and actions, including financial and operational priorities, are consistent with and support the firm’s commitment to quality.
- e. The firm’s organizational and governance structure and the assignment of roles, responsibilities, and authority enable the design, implementation, and operation of the firm’s QC system and support performance of the firm’s *engagements* in accordance with *applicable professional and legal requirements*.

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<sup>8</sup> See paragraph .46.

- f. Resource needs are planned for, and resources are obtained or developed and allocated or assigned, in a manner that enables the effective design, implementation, and operation of the firm’s QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements*.

Note: Resources include people, financial, technological, and intellectual resources, and resources from a network or *third-party provider*.<sup>9</sup>

### **Governance and Leadership Specified Quality Responses**

.26 In designing and implementing *quality responses* to address the *quality risks* in the governance and leadership component, the firm should include the specified *quality responses* in paragraphs .27-.29. These specified *quality responses* alone will not be sufficient to enable the firm to achieve all established *quality objectives* for this component. Depending on the *quality risk* being addressed, specified *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

.27 The firm should establish and maintain clear lines of responsibility and supervision—including defining authorities, responsibilities, accountabilities, and supervisory and reporting lines for roles within the firm, up to and including the principal executive officer(s)<sup>10</sup> or equivalent—within the QC system.

.28 If the firm issued audit reports with respect to more than 100 issuers during the prior calendar year, the firm’s governance structure should incorporate an oversight function for the audit practice that includes at least one person who is not a partner, shareholder, member, other principal, or employee of the firm and does not otherwise have a commercial, familial, or other relationship with the firm that would interfere with the exercise of independent judgment with regard to matters related to the QC system.

.29 The firm should design, implement, and maintain policies and procedures for addressing and resolving potential noncompliance with *applicable professional and legal requirements* and with the firm’s policies and procedures with respect to the QC system, the firm’s *engagements*, *firm personnel*, or *other participants*, including for:

- a. Receiving complaints and allegations from internal and external parties (for example, policies and procedures regarding a complaints mailbox or hotline or a whistleblower program); and
- b. Investigating and addressing complaints and allegations.

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<sup>9</sup> See paragraphs .44h. and .44i. for an explanation of technological and intellectual resources.

<sup>10</sup> See paragraph .11.

Note: The nature, timing, and extent of the process to investigate and resolve complaints and allegations should be commensurate with and responsive to the significance of the related complaint or allegation.

## Ethics and Independence

.30 The ethics and independence component addresses the fulfillment of firm and individual responsibilities under ethics and independence requirements.<sup>11</sup>

### Ethics and Independence Quality Objectives

.31 The *quality objectives* established by the firm with respect to ethics and independence requirements should include the following:

- a. Ethics and independence requirements are understood and complied with by the firm and *firm personnel* and, with respect to work performed on behalf of the firm, by others subject to such requirements.<sup>12</sup>
- b. Conditions, events, relationships, or activities that could constitute violations of ethics and independence requirements are properly identified, evaluated, and responded to by the firm and *firm personnel* on a timely basis.
- c. Violations are communicated on a timely basis to the individual assigned operational responsibility for the firm’s compliance with ethics and independence requirements.

### Ethics and Independence Specified Quality Responses

.32 In designing and implementing *quality responses* to address the *quality risks* in the ethics and independence component, the firm must include the specified *quality responses* in paragraphs .33 -.36. These specified *quality responses* alone will not be sufficient to enable the firm to achieve all established *quality objectives* for this component. Depending on the *quality*

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<sup>11</sup> Ethics and independence requirements include PCAOB independence and ethics standards and rules, the Securities and Exchange Commission (“SEC”) rule on auditor independence, and other applicable requirements regarding accountant ethics and independence, such as those arising under state law or the law of other jurisdictions. *See, e.g.*, Regulation S-X Rule 2-01, 17 C.F.R. § 210.2-01, and PCAOB rules under Section 3. Auditing and Related Professional Practice Standards, Part 5 – Ethics and Independence.

<sup>12</sup> Others subject to such requirements may include, for example, “associated persons” of a firm (as defined in PCAOB Rule 1001(p)(i)) and “covered persons in the firm” (as defined in Regulation S-X Rule 2-01(f)(11), 17 C.F.R. § 210.2-01(f)(11)) that in each case are not *firm personnel*.

*risk* being addressed, specified *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

.33 The firm must design, implement, and maintain policies and procedures that address ethics and independence requirements, including:

- a. Identifying and addressing matters that may reasonably be thought to bear on the independence of the firm, *firm personnel*, and affiliates of the firm;<sup>13</sup>
- b. Obligations of *firm personnel* to perform with integrity and objectivity all activities associated with the operation of the QC system and the performance of *engagements* (such as training and other professional development activities; *engagement* planning, performance, and supervision; and communication with clients, other *firm personnel*, and regulators);<sup>14</sup>
- c. Obligations of associated persons of the firm,<sup>15</sup> other than *firm personnel*, to perform work on behalf of the firm with integrity and objectivity;
- d. Consultations on ethics and independence matters, including identifying ethics and independence matters requiring consultation;
- e. Monitoring compliance (e.g., internal inspection of independence compliance at least annually) with applicable ethics and independence requirements and related firm policies and procedures by the firm, affiliates of the firm, *firm personnel*, and, with respect to work performed on behalf of the firm, others subject to such requirements; and
- f. With respect to violations and potential violations of ethics and independence requirements:
  - (1) Identifying conditions, events, relationships, or activities that could constitute ethics or independence violations involving the firm, *firm personnel*, and, with

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<sup>13</sup> PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*, requires the firm to communicate with the audit committee regarding matters that may reasonably be thought to bear on the independence of the firm, *firm personnel*, and affiliates of the firm. Some, but not all, such matters are the subject of specific SEC or PCAOB requirements. See, e.g., Rule 2-01 of Regulation S-X, 17 C.F.R. § 210.2-01; PCAOB Rule 3522, *Tax Transactions*; PCAOB Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*.

<sup>14</sup> See PCAOB Rule 3500T, *Interim Ethics and Independence Standards*; ET 1000, *Integrity and Objectivity* [as proposed].

<sup>15</sup> See PCAOB Rule 1001(p)(i).

respect to work performed on behalf of the firm, others subject to such requirements;

- (2) Taking preventive and corrective actions to address ethics or independence violations, as appropriate, on a timely basis;
- (3) Reporting requirements for *firm personnel* and, with respect to work performed on behalf of the firm, *other participants* regarding ethics or independence violations of which they become aware that may affect the firm, including requirements for escalating reporting of such violations; and
- (4) Communicating, as appropriate, to external parties (for example, to audit committees).<sup>16</sup>

.34 The firm’s policies and procedures for matters that may reasonably be thought to bear on the independence of the firm, *firm personnel*, and affiliates of the firm (see paragraph .33a.) must include:

- a. Identifying firm and personal relationships and arrangements with restricted entities, including a process for identifying direct or material indirect financial interests that might impair the firm’s independence of *firm personnel* that are managerial employees or partners, shareholders, members, or other principals.
  - (1) If the firm issued audit reports with respect to more than 100 issuers during the prior calendar year, such process should be automated.
  - (2) If the firm issued audit reports with respect to 100 or fewer issuers during the prior calendar year, the firm should consider automating such process, taking into account the *quality risks* and the nature and circumstances of the firm.

Note: Firm and personal relationships and arrangements with restricted entities include financial relationships, employment relationships, business relationships, non-audit services, contingent fee arrangements, partner rotation, certain tax services, and arrangements requiring audit committee pre-approval.<sup>17</sup> The term

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<sup>16</sup> See paragraph .A2 of AS 1301, *Communications with Audit Committees*, for the definition of audit committee.

<sup>17</sup> See, e.g., Regulation S-X Rule 2-01(c), 17 C.F.R. § 210.2-01(c); PCAOB Rules 3522 and 3523.

“restricted entities” includes all audit clients (including affiliates of the audit client) of the firm and affiliates of the firm.<sup>18</sup>

- b. Maintaining and making available the list of restricted entities to *firm personnel* and others performing work on behalf of the firm who are subject to independence requirements;

Note: This includes updating and communicating changes to the list of restricted entities at least monthly (and more frequently, if appropriate) to *firm personnel* and others performing work on behalf of the firm who are subject to independence requirements.

- c. Requiring that the list of restricted entities be reviewed before the firm enters into any relationships, *engagements* to perform non-audit services, or fee arrangements that might affect compliance with independence requirements, and, if such review indicates that action is required under *applicable professional and legal requirements* or the firm’s policies and procedures, taking required actions on a timely basis;
- d. Requiring *firm personnel* to review the list of restricted entities (1) upon employment or engagement, (2) after changes to the list of restricted entities are communicated by the firm, (3) prior to themselves or a relevant family member<sup>19</sup> obtaining any direct or material indirect financial interest in or entering into or modifying a direct or material indirect relationship with an entity, (4) prior to changes in position (e.g., going into a chain of command or other covered person role<sup>20</sup>), and (5) prior to entering into any business or employment relationships, and, if such review indicates that action is required under *applicable professional and*

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<sup>18</sup> “Audit client” is defined for purposes of SEC rules in Regulation S-X Rule 2-01(f)(6), 17 C.F.R. § 210.2-01(f)(6), and for purposes of PCAOB rules in PCAOB Rule 3501(a)(iv). “Affiliate of the audit client” is defined in PCAOB Rule 3501(a)(ii) as having the same meaning as defined in Regulation S-X Rule 2-01(f)(4), 17 C.F.R. § 210.2-01(f)(4). “Affiliate of the accounting firm” is defined in PCAOB Rule 3501(a)(i), and, for purposes of this Note to paragraph .34a., “accounting firm,” which includes the firm’s associated entities, is defined in Regulation S-X Rule 2-01(f)(2), 17 C.F.R. § 210.2-01(f)(2).

<sup>19</sup> Context determines which family members would be relevant. *See, e.g.,* Regulation S-X Rule 2-01(f)(9), 17 C.F.R. § 210.2-01(f)(9) (defining “close family members”); Regulation S-X Rule 2-01(f)(13), 17 C.F.R. § 210.2-01(f)(13) (defining “immediate family members”); *see generally* Regulation S-X Rule 2-01(c), 17 C.F.R. § 210.2-01(c) (referring to “close family member” or “immediate family member” depending on the context).

<sup>20</sup> *See* Regulation S-X Rule 2-01(f)(11), 17 C.F.R. § 210.2-01(f)(11) (defining “covered persons in the firm”).

- legal requirements* or the firm’s policies and procedures, taking required actions on a timely basis;
- e. Obtaining certifications from *firm personnel* regarding familiarity and compliance with SEC and PCAOB independence requirements and the firm’s independence policies and procedures (1) upon employment, (2) at least annually thereafter, and (3) upon any change in personal circumstances, such as role, geographic location, or marital status, that is relevant to independence; and
  - f. Identifying matters that require audit committee pre-approval and obtaining such pre-approval.<sup>21</sup>

.35 The firm must make available its ethics and independence policies and procedures to *firm personnel* and others performing work on behalf of the firm who are subject to ethics and independence requirements, including communicating any substantive changes to such policies and procedures on a timely basis.

.36 The firm must provide mandatory training to *firm personnel* near the time of initial employment and periodically (at least annually) thereafter that addresses ethics and independence requirements and the firm’s ethics and independence policies and procedures.

## Acceptance and Continuance of Client Relationships and Specific Engagements

.37 This component addresses the firm’s processes for making decisions about whether to accept or continue a client relationship or a specific *engagement*.

### Acceptance and Continuance Quality Objectives

.38 The *quality objectives* established by the firm with respect to the acceptance and continuance of client relationships and specific *engagements* should include the following:

- a. Judgments about whether to accept or continue a client relationship or specific *engagement* are:
  - (1) Made as part of or before performing preliminary *engagement* activities;<sup>22</sup>

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<sup>21</sup> See, e.g., Regulation S-X Rule 2-01(c)(7), 17 C.F.R. § 210.2-01(c)(7); PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*; PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*.

<sup>22</sup> See, e.g., paragraph .06 of AS 2101, *Audit Planning*.

- (2) Consistent with the firm’s ability to perform the *engagement* in accordance with *applicable professional and legal requirements*, based on:
- (a) Whether the firm is independent;
  - (b) Whether the services are permissible and any required audit committee pre-approval has been or will be obtained;<sup>23</sup>
  - (c) The extent to which the firm is or will be able to gain access to client information to perform the *engagement*, including to client personnel who provide such information;
  - (d) The extent to which the firm has or can obtain resources to perform the *engagement*;<sup>24</sup> and
  - (e) Other relevant factors associated with providing professional services in the particular circumstances; and
- (3) Based on and supported by information about the nature and circumstances of the *engagement* and the integrity and ethical values of the client (including management and the audit committee).<sup>25</sup>
- b. The terms of the *engagement*, including the objective of the *engagement* and responsibilities of the firm and management, are consistent with *applicable professional and legal requirements*, and are understood by the firm and the client.<sup>26</sup>

### Acceptance and Continuance Specified Quality Response

.39 In designing and implementing *quality responses* to address the *quality risks* in the acceptance and continuance of client relationships and specific *engagements* component, the firm should include the specified *quality response* in paragraph .40. This specified *quality response* alone will not be sufficient to enable the firm to achieve all established *quality*

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<sup>23</sup> See, e.g., Regulation S-X Rule 2-01(c)(7), 17 C.F.R. § 210.2-01(c)(7); PCAOB Rule 3524; PCAOB Rule 3525.

<sup>24</sup> See, for example, paragraph .06H of AS 2101, *Audit Planning* [effective for audits for fiscal years ending on or after December 15, 2024], and paragraph .08 of AS 1210, *Using the Work of an Auditor-Engaged Specialist*, when evaluating when such resources are or will be involved in the *engagement*.

<sup>25</sup> For a prospective *engagement*, this includes evaluating information obtained from a predecessor firm. See generally, e.g., AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors*.

<sup>26</sup> See, e.g., AS 1301.05.

*objectives* for this component. Depending on the *quality risk* being addressed, specified *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

.40 The firm should establish policies and procedures to address situations in which the firm becomes aware of information subsequent to accepting or continuing a client relationship or specific *engagement* that could have caused the firm to decline such relationship or *engagement* had that information been known prior to acceptance or continuance.<sup>27</sup>

## Engagement Performance

.41 This component addresses the firm’s processes relating to the performance of the firm’s *engagements* by *firm personnel* and *other participants* in accordance with *applicable professional and legal requirements*.

### Engagement Performance Quality Objectives

.42 The *quality objectives* established by the firm with respect to the performance of its *engagements*, including work performed on other firms’ *engagements*, should include the following:

- a. Responsibilities are understood and fulfilled by *firm personnel* and *other participants* in accordance with *applicable professional and legal requirements*, including, as applicable:<sup>28</sup>
  - (1) The responsibilities of the engagement partner for an *engagement* and its performance;<sup>29</sup>
  - (2) Responsibilities for planning and performing the *engagement*, including:

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<sup>27</sup> For purposes of this standard, the firm is “aware” of information if any partner, shareholder, member, or other principal of the firm is aware of such information.

<sup>28</sup> See PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*, which requires compliance with all applicable auditing and related professional practice standards adopted by the Board and approved by the SEC.

<sup>29</sup> For purposes of this standard, the “practitioner with final responsibility” in AT Section 101, *Attest Engagements*, is treated as the “engagement partner.”

- (a) Exercising due professional care, including professional skepticism, such that conclusions reached are appropriate under *applicable professional and legal requirements* and supported by sufficient appropriate evidence;<sup>30</sup> and
  - (b) Properly supervising the work performed by *firm personnel* and *other participants*;<sup>31</sup> and
  - (3) Responsibilities for reporting and other communications with respect to the *engagement*.
- b. Consultations on complex, unusual, or unfamiliar accounting and auditing matters are undertaken with qualified individuals from within or outside the firm, and conclusions are:
- (1) Agreed to by the engagement partner and the parties consulted;
  - (2) In accordance with *applicable professional and legal requirements*; and
  - (3) Implemented before the issuance of the *engagement* report.<sup>32</sup>
- c. Differences in professional judgment related to the *engagement* that arise among *firm personnel*, among *other participants*, or between *firm personnel* and *other participants*, including the engagement quality reviewer or those that provide consultation, are brought to the attention of the individual(s) with responsibility and authority for resolving such matters and are resolved before the issuance of an *engagement* report, such that the *engagement* is performed in accordance with *applicable professional and legal requirements*.<sup>33</sup>
- d. *Engagement* documentation is prepared, reviewed, assembled, and retained in accordance with *applicable professional and legal requirements*.<sup>34</sup>

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<sup>30</sup> See generally, e.g., AS 1015; AT Section 101.

<sup>31</sup> See generally, e.g., AS 1201, *Supervision of the Audit Engagement*.

<sup>32</sup> Consultation does not alter the responsibilities of the engagement partner for designing and performing procedures to obtain sufficient appropriate evidence to support the *engagement* report. See generally, e.g., AS 1201.

<sup>33</sup> See, for example, paragraph .48 of AT Section 101, regarding the elements of supervision, including dealing with differences of opinion among personnel, and paragraph .12d of AS 1215, *Audit Documentation*, regarding documentation of disagreements.

<sup>34</sup> See generally AS 1215.

## Resources

.43 This component addresses the firm’s processes for obtaining, developing, using, maintaining, allocating, and assigning the firm’s resources to enable the design, implementation, and operation of the firm’s QC system and the performance of its *engagements*. The firm’s resources include people, financial, technological, and intellectual resources, and resources from a network or *third-party provider*.

### Resources Quality Objectives

.44 The *quality objectives* established by the firm with respect to the firm’s resources should include the following:

- a. *Firm personnel* are hired, developed, and retained who have the competence to perform activities and carry out responsibilities for the operation of the firm’s QC system and the performance of the firm’s *engagements* in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures.<sup>35</sup>

Note: Competence consists of having the knowledge, skill, and ability that enable individuals to act in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures. The measure of competence is qualitative rather than quantitative because quantitative measurement may not accurately reflect the experience gained by *firm personnel* over time.

- b. *Firm personnel* demonstrate a commitment to quality through (1) their actions and behaviors and (2) development and maintenance of the competence to perform their roles.
- c. Individuals who are assigned to *engagements*, including the engagement partner and engagement quality reviewer, have the competence, objectivity, and time to fulfill their responsibilities on such *engagements* in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures.
- d. *Firm personnel* who are assigned to participate in another firm’s *engagement* have the competence, objectivity, and time to perform such activities in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures.

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<sup>35</sup> For certain specified activities and responsibilities of certain *firm personnel*, see paragraphs .11-.17.

- e. Individuals who are assigned to perform activities within the QC system have the competence, objectivity, authority, and time to perform such activities in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures.<sup>36</sup>
- f. *Firm personnel* comply with the firm’s policies and procedures related to the operation of the firm’s QC system and the performance of its *engagements* and the work performed on other firms’ *engagements*.
- g. *Firm personnel* are (1) evaluated at least annually, (2) incentivized to fulfill their assigned responsibilities and adhere to appropriate standards of conduct, and (3) held accountable for their actions and failures to act.<sup>37</sup>
- h. Technological resources are obtained or developed, implemented, maintained, and used to enable the operation of the firm’s QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures.

Note: Technological resources generally include information technology applications, infrastructure, and processes.

- i. Intellectual resources are obtained or developed, implemented, maintained, and used to enable the operation of the firm’s QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures.

Note: Intellectual resources generally include resources that a firm makes available, or requires the use of, in the performance of its *engagements*, including, for example, the firm’s policies and procedures, methodologies, guides, practice aids, and standardized documentation templates.

- j. If the firm belongs to a network that provides or requires the use of network resources or services or if the firm obtains resources or services from a *third-party provider*:<sup>38</sup>

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<sup>36</sup> These individuals include engagement quality reviewers and those performing activities within the QC system, such as monitoring activities.

<sup>37</sup> Paragraph .46 describes appropriate standards of conduct by *firm personnel*.

<sup>38</sup> Resources acquired from a *third-party provider* may include methodologies, applications, and tools used in the firm’s QC system or the performance of its *engagements*.

- (1) An understanding is obtained of how such resources or services are developed and maintained; and
- (2) Such resources or services are supplemented or adapted as necessary such that their use enables the operation of the firm’s QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures.

### Resources Specified Quality Responses

.45 In designing and implementing *quality responses* to address the *quality risks* in the resources component, the firm should include the specified *quality responses* in paragraphs .46-.51. These specified *quality responses* alone will not be sufficient to enable the firm to achieve all established *quality objectives* for this component. Depending on the *quality risk* being addressed, specified *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

.46 The firm should design, implement, and maintain policies and procedures for *firm personnel* to adhere to appropriate standards of conduct, which include:

- a. Fulfilling *engagement* and QC responsibilities with competence, integrity, objectivity, and due professional care; and
- b. Complying with *applicable professional and legal requirements* and the firm’s policies and procedures.

.47 The firm should design, implement, and maintain policies and procedures for the engagement partner and, commensurate with their responsibilities, others participating in an *engagement* to obtain and maintain the competence to fulfill their respective assigned *engagement* roles,<sup>39</sup> including an understanding of the following:

- a. The importance of exercising sound judgment, including the ability to be objective and exercise professional skepticism;
- b. The role of the firm’s QC system in the performance of its *engagements* (e.g., engagement quality reviews, consultation process);
- c. Their responsibilities with respect to the performance and supervision of the *engagement*;

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<sup>39</sup> See, e.g., AS 1015.06; paragraph .05 of AS 1220, *Engagement Quality Review*.

- d. For attestation *engagements*, the subject matter of the assertion on which the *engagement* is based;
- e. The industry in which the client operates and its relevant characteristics (e.g., applicable standards, industry-specific risks, and industry-specific estimates);
- f. The internal control framework used by the client;
- g. The use of technology by the client in the preparation of its financial statements and related internal controls; and
- h. The use of technological and intellectual resources in performing *engagement* procedures, including obtaining and evaluating evidence.

.48 In addition to the training required under paragraph .36, at least annually, the firm should provide mandatory training, including training on *applicable professional and legal requirements*, to *firm personnel* to develop and maintain their competence and enable them to fulfill their assigned QC and *engagement* roles in accordance with *applicable professional and legal requirements* and the firm's policies and procedures.

.49 The firm's periodic performance evaluations of the individual(s) assigned (1) ultimate responsibility and accountability for the QC system as a whole and (2) operational responsibility and accountability for the QC system as a whole should take into account the outcome of the evaluation of the QC system.

.50 The firm should design, implement, and maintain policies and procedures regarding licensure such that the firm and *firm personnel* hold licenses or other qualifications required by the relevant jurisdiction(s) under *applicable professional and legal requirements*.

.51 The firm should design, implement, and maintain policies and procedures so that technological resources have the capacity, integrity, resiliency, availability, reliability, and security necessary to enable the operation of the firm's QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements*.

## Information and Communication

.52 This component addresses the firm's processes for obtaining, generating, and using information to enable the design, implementation, and operation of the QC system and the performance of its *engagements*, and for communicating information within the firm and to external parties on a timely basis.

## Information and Communication Quality Objectives

.53 The *quality objectives* established by the firm with respect to information and communication should include the following:

- a. Information, whether from internal or external sources, is identified, captured, processed, and maintained by the firm’s information system(s) to support the operation of the firm’s QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements*.
- b. The nature, timing, and extent of information communicated to *firm personnel* enables them to understand and carry out their responsibilities relating to activities within the firm’s QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures.
- c. *Firm personnel* communicate information to the firm and other *firm personnel* to support the operation of the QC system and the performance of the firm’s *engagements* in accordance with *applicable professional and legal requirements*.
- d. Information is communicated to external parties in accordance with *applicable professional and legal requirements*.

Note: External parties may include, for example, company management, audit committees, and boards of directors; the SEC; the PCAOB; and other regulators.<sup>40</sup>

- e. If a firm communicates firm-level or *engagement*-level information, such as firm or *engagement* performance metrics, to external parties, such information is accurate and not misleading and, with respect to any performance metrics, explains in reasonable detail how the metrics were determined and, if applicable, how the metrics or the method of determining them changed since performance metrics were last communicated.
- f. If the firm belongs to a network, information is communicated to or obtained from the network to enable the operation of the firm’s QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements*.

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<sup>40</sup> See, e.g., AS 1301; PCAOB Rules 3524, 3525, and 3526; Section 10A(b) and (k) of the Securities Exchange Act of 1934 (“Exchange Act”), 15 U.S.C. § 78j-1(b), (k); Regulation S-X Rule 2-07, 17 C.F.R. § 210.2-07; Rule 10A-1 under the Exchange Act, 17 C.F.R. § 240.10A-1.

g. If *other participants* are used in the firm's *engagements*:

- (1) The nature, timing, and extent of information communicated to *other participants* enables them to understand and carry out their responsibilities relating to activities within the firm's QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements* and the firm's policies and procedures; and
- (2) Information is obtained from the *other participants*, such that those *engagements* can be performed in accordance with *applicable professional and legal requirements*.<sup>41</sup>

Note: With respect to *other participants* that are firms, information to be obtained should include the conclusion of the most recent evaluation of the QC system<sup>42</sup> of the *other participant* firm and a brief overview of remedial actions taken and to be taken.

h. If the firm participates in another firm's *engagement*, information is communicated to and obtained from the other firm such that the firm's work on the *engagement* is performed in accordance with *applicable professional and legal requirements*.

Note: This communication includes any instances of noncompliance with *applicable professional and legal requirements* that the firm identifies related to the other firm's *engagements* during the firm's monitoring and remediation procedures.

### Information and Communication Specified Quality Responses

.54 In designing and implementing *quality responses* to address the *quality risks* in the information and communication component, the firm should include the specified *quality responses* in paragraphs .55 -.57. These specified *quality responses* alone will not be sufficient to enable the firm to achieve all established *quality objectives* for this component. Depending

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<sup>41</sup> See, e.g., AS 1201.08-.13 [effective for audits for fiscal years ending on or after December 15, 2024].

<sup>42</sup> The most recent evaluation of the *other participant* firm's QC system refers to that firm's evaluation under paragraph .77 of this standard as of the most recent November 30, if such an evaluation was performed. If the *other participant* firm did not evaluate its QC system under paragraph .77 of this standard as of the most recent November 30, then this provision refers to the most recent QC evaluation performed by the *other participant* firm under any professional standard.

on the *quality risk* being addressed, specified *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

.55 The firm should communicate in writing its policies and procedures related to the operation of the firm’s QC system and the performance of its *engagements to firm personnel* and *other participants* in a manner that is reasonably designed and implemented to enable *firm personnel* and *other participants* to understand and carry out their responsibilities relating to activities within the firm’s QC system and the performance of its *engagements* in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures.

.56 The firm should communicate information related to the monitoring and remediation process to *firm personnel* to enable them to take timely action in accordance with their responsibilities, including, to the extent necessary, a description of:

- a. Monitoring activities performed and the results of such activities, including, if applicable, monitoring activities performed by the network;
- b. Identified *engagement deficiencies* and *QC deficiencies*, including the nature, severity, and pervasiveness of such deficiencies; and
- c. Actions to address the identified *engagement deficiencies* and *QC deficiencies*.

.57 The firm should communicate the result of the annual evaluation of the firm’s QC system to the firm’s partners, shareholders, members, or other principals, and the firm’s board of directors or equivalent.

## Monitoring and Remediation Process

.58 The monitoring and remediation process is an integral part of a QC system because it informs the firm’s risk assessment process (i.e., the results of the monitoring and remediation process are taken into account when determining if changes to *quality objectives*, *quality risks*, or *quality responses* are necessary). The monitoring and remediation process applies to all of the components of the QC system, including monitoring and remediation, and provides the basis for evaluating and reporting on the QC system.

.59 The firm must design, implement, and operate a monitoring and remediation process to:

- a. Provide relevant, reliable, and timely information about the design, implementation, and operation of the QC system;
- b. Provide a reasonable basis for detecting *engagement deficiencies* and *QC deficiencies*; and

c. Remediate identified *engagement deficiencies* and *QC deficiencies* on a timely basis.

.60 The firm’s monitoring and remediation process includes:

- a. Designing and performing activities to monitor *engagements* and the design, implementation, and operation of the QC system (see paragraphs .62-.66);
- b. Determining whether *engagement deficiencies* exist and responding to such deficiencies (see paragraphs .67-.70);
- c. Determining whether *QC findings* and *QC deficiencies* exist (see paragraphs .71-.72);
- d. Performing root cause analysis of *QC deficiencies* (see paragraphs .73-.74); and
- e. Designing and implementing remedial actions to address *QC deficiencies* and determining whether such actions are implemented as designed and operate effectively (see paragraphs .75-.76).

.61 The firm’s monitoring activities must include:

- a. “*Engagement* monitoring activities,” which are directed at individual *engagements*; and
- b. “QC system-level monitoring activities,” which are directed at the performance of activities under the requirements of this standard, including requirements relating to the components of the QC system.

### **Engagement Monitoring Activities**

.62 The firm should:

- a. Monitor completed *engagements*; and
- b. As one element of its *engagement* monitoring, inspect on a cyclical basis at least one completed *engagement* for each engagement partner.

Note: A firm that uses a cycle longer than three years should demonstrate how that cycle is adequate to provide a reasonable basis for detecting *engagement deficiencies* and *QC deficiencies*, taking into account the factors in paragraph .64. Firms should consider incorporating a level of unpredictability in their selection of completed *engagements*, such that an engagement partner would not be certain which *engagement* would be selected or when an *engagement* would be selected.

- .63 In addition to monitoring completed *engagements*,
- a. If the firm issued audit reports with respect to more than 100 issuers during the prior calendar year, the firm should monitor in-process *engagements*;
  - b. If the firm issued audit reports with respect to 100 or fewer issuers during the prior calendar year, the firm should consider monitoring in-process *engagements*; and
  - c. If the firm participates at a level below a substantial role in another firm's *engagement*, the firm should consider performing monitoring activities on such work.

.64 In determining the nature, timing, and extent of *engagement* monitoring activities, including which completed or in-process *engagements* to select for monitoring, the firm should take into account the following factors:

- a. *Quality risks* and the reasons they were assessed to be *quality risks*;
- b. The design of *quality responses*, including their intended timing, frequency, and scope;
- c. The nature, timing, extent, and results of previous monitoring activities undertaken by the firm and, if applicable, the network, including from inspections of completed *engagements*, inspections of in-process *engagements*, monitoring of work performed on other firms' *engagements*, and QC system-level monitoring activities;
- d. Information obtained from oversight activities by regulators, other external inspections or reviews, and, if applicable, monitoring activities performed by the network;

Note: The firm cannot rely solely on monitoring activities performed by others (e.g., network activities, regulatory inspections, or peer reviews) in lieu of performing its own inspections of completed *engagements*.

- e. Characteristics of particular *engagements*, such as the industry, the type of *engagement* (e.g., issuer audit, broker-dealer audit, attestation), the location(s) or jurisdiction(s) in which the client is located or the work is to be performed, whether it is a new *engagement* for the firm, and the experience and competence of the individuals assigned to the *engagement*;
- f. Characteristics of particular engagement partners, such as their experience, their competence, the results of internal and external inspections of their work, and the firm's cycle for inspecting their *engagements*; and

- g. Other information relevant to the risks of noncompliance with *applicable professional and legal requirements*, such as emerging developments, changes in economic conditions, new accounting or auditing standards, circumstances in which the firm has withdrawn its *engagement* report, restatements, complaints and allegations of which the firm is aware,<sup>43</sup> and other events affecting one or more *engagements*.

### QC System-Level Monitoring Activities

.65 In determining the nature, timing, and extent of QC system-level monitoring activities, the firm should take into account the following factors:

- a. *Quality risks* and the reasons they were assessed to be *quality risks*;
- b. The design of *quality responses*, including their intended timing, frequency, and scope;
- c. For monitoring activities over the firm’s risk assessment process and monitoring and remediation process, the design of those processes (including any performance metrics that the firm may have developed for its QC system);
- d. Changes or anticipated changes in the QC system;
- e. The services or resources provided by *other participants* or *third-party providers* in the firm’s QC system, when applicable;
- f. The results of previous monitoring activities and remedial actions taken to address previously identified *QC deficiencies*;
- g. Information obtained from oversight activities by regulators, other external inspections or reviews, and, if applicable, monitoring activities performed by the network;

Note: The firm cannot rely solely on monitoring activities performed by others (e.g., network activities, regulatory inspections, or peer reviews) in lieu of performing QC system-level monitoring activities.

- h. Complaints and allegations of which the firm is aware; and
- i. Other relevant information of which the firm is aware.

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<sup>43</sup> With respect to the aspects of the monitoring and remediation process that are based on the firm’s awareness, see footnote 26.

### Monitoring Activities Performed by the Network

.66 In circumstances when the network performs monitoring activities relating to the firm’s QC system or its *engagements*, the firm should:

- a. Request and, if provided, evaluate:
  - (1) Information about the activities performed;
  - (2) Results of such activities; and
  - (3) Planned remedial actions by the network;
- b. Determine its responsibilities in relation to the monitoring activities of the network, such as assisting with monitoring activities or responding to the results of the activities performed by the network, and perform such responsibilities; and
- c. Adjust its monitoring activities as necessary.

Note: Network monitoring activities may include, for example, monitoring the effectiveness of network resources or services that firms in the network are required to or may use in their QC system and monitoring of other aspects of the firm’s QC system and its *engagements*.

### Determining Whether Engagement Deficiencies Exist

.67 The firm must evaluate the following information and, on a timely basis, determine whether *engagement deficiencies* exist:

- a. Information from *engagement* monitoring activities;
- b. *QC deficiencies* identified by QC system-level monitoring activities, as provided in paragraph .72;
- c. Information from monitoring activities performed by the network, if applicable;
- d. Information from oversight activities by regulators and other external inspections or reviews; and
- e. Other relevant information of which the firm becomes aware.

Note: The firm may become aware of other relevant information through, for example: (1) documentation being assembled for retention; (2) procedures performed on the subsequent year’s *engagement*; (3) post-balance sheet

review activities in connection with a securities offering; (4) whistleblower complaints; and (5) restatements.

### Responding to Engagement Deficiencies

.68 When an *engagement deficiency* exists, the firm should:

- a. For *engagement deficiencies* relating to in-process *engagements*, take action to address the deficiency in accordance with *applicable professional and legal requirements* (to the extent necessary, before the issuance of the related *engagement* report(s)), such that the *engagement* report is appropriate in the circumstances;
- b. For *engagement deficiencies* relating to completed *engagements*, take action to address the deficiency in accordance with *applicable professional and legal requirements*,<sup>44</sup> unless it is probable that the *engagement* report(s) are not being relied upon;<sup>45</sup>

Note: The firm must treat as relied upon any *engagement* report that is included in the most recent filing on an SEC form that requires inclusion of such an *engagement* report.

- c. For *engagement deficiencies* relating to work performed on other firms' *engagements*, communicate the *engagement deficiency* to the other firm and take such remedial action as the other firm determines is necessary; and
- d. Evaluate whether similar *engagement deficiencies* exist on:
  - (1) Other in-process *engagements*, or would arise if remedial action is not taken;
  - (2) Other completed *engagements*, unless it is probable that the *engagement* report(s) are not being relied upon; and
  - (3) Work performed by the firm on other firms' *engagements*;and if so, take actions described in .68a.-c. above, as applicable.

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<sup>44</sup> See paragraph .70.

<sup>45</sup> The term “probable” has the same meaning as used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

.69 The firm should take action pursuant to paragraph .68, taking into account the nature and severity of the *engagement deficiency*.

Note: Remedial actions a firm may take include: (1) corrective actions on in-process *engagements* to address *engagement deficiencies* before the issuance of the *engagement* report; (2) corrective actions to address *engagement deficiencies* on completed *engagements*; and (3) preventive actions to deter future *engagement deficiencies*.

.70 For each *engagement deficiency* relating to a completed *engagement*, the firm should comply with paragraphs .98-.99 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* [as proposed to be amended], AS 2901 *Responding to Engagement Deficiencies After Issuance of the Auditor's Report* [as proposed to be amended], AS 2905, paragraphs 39.-42. of AT No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* [as proposed to be amended], and paragraphs 21.-24. of AT No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* [as proposed to be amended], as applicable.

#### **Determining Whether QC Findings Exists**

.71 The firm must evaluate the following information and, on a timely basis, determine whether *QC findings* exist:

- a. Information from *engagement* monitoring activities and QC system-level monitoring activities (including, if applicable, those performed by the network);
- b. Information from oversight activities by regulators and other external inspections or reviews; and
- c. Other relevant information of which the firm becomes aware.

#### **Determining Whether QC Deficiencies Exist**

.72 The firm must evaluate *QC findings* to determine, on a timely basis, whether *QC deficiencies* exist. The firm's determination should be based on:

- a. The nature, severity, and pervasiveness of the matter(s) that gave rise to the *QC finding*, which includes:
  - (1) The component(s) of the QC system, *quality objective(s)*, or *quality risk(s)* to which the *QC finding* relates;
  - (2) Whether the *QC finding* is in the design, implementation, or operation of the QC system;

- (3) The frequency with which the *QC finding* occurred; and
  - (4) The duration of time that the *QC finding* existed; and
- b. The likelihood that the matter(s) that gave rise to the *QC finding* could affect other components of the QC system, other *engagements* (including in-process *engagements* and completed *engagements*), *engagements* to be performed in the future, or work performed on other firms' *engagements*, and the severity of such an effect if it were to occur.

### Responding to QC Deficiencies

.73 The firm should perform root cause analysis of all *QC deficiencies*. Root cause analysis involves identifying and evaluating the causal factors that led to each *QC deficiency*. The firm may perform root cause analysis of *QC deficiencies* individually or may group similar *QC deficiencies* together.

.74 The nature, timing, and extent of the root cause analysis should be commensurate with the nature, severity, and pervasiveness of the *QC deficiency*.

.75 For each *QC deficiency*, the firm should design and implement timely remedial actions, taking into account the results of its root cause analysis and the nature, severity, and pervasiveness of the *QC deficiency*.

Note: When performing root cause analysis and identifying potential remedial actions for a *QC deficiency*, it may be beneficial for firms to consider actions, behaviors, or conditions that resulted in positive outcomes, such as where aspects of its QC system operate effectively or where no *engagement deficiencies* were identified for individual *engagements*. This information could provide useful insights when evaluating situations where *QC deficiencies* were identified and such actions, behaviors, or conditions were not present or were not present to the same degree.

.76 The firm should monitor the implementation and operating effectiveness of remedial actions to address the *QC deficiency* and determine whether such actions are implemented as designed and operate effectively to remediate the *QC deficiency*. If those actions do not remediate the *QC deficiency*, the firm should take timely action until the *QC deficiency* is remediated.<sup>46</sup>

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<sup>46</sup> See paragraphs .64 and .65 when determining the nature, timing, and extent of monitoring activities for remedial actions.

## Evaluating and Reporting on the QC System

### Annual Evaluation of the QC System

.77 Annually, the firm must evaluate the effectiveness of its QC system, based on the results of its monitoring and remediation activities, and conclude, as of November 30 (the “evaluation date”), that its QC system:

- a. Is effective with no unremediated *QC deficiencies*; or
- b. Is effective except for one or more unremediated *QC deficiencies* that are not *major QC deficiencies*; or
- c. Is not effective (one or more *major QC deficiencies* exists).

Note: An unremediated QC deficiency is one for which remedial actions that completely address the QC deficiency have not been fully implemented, tested, and found effective.

### Determining Whether Major QC Deficiencies Exist

.78 As of the evaluation date, the firm must evaluate unremediated *QC deficiencies* to determine whether *major QC deficiencies* exist. The firm’s determination should be based on the following factors:

- a. The severity and pervasiveness of the unremediated *QC deficiencies*, which may be evidenced by, for example:
  - (1) The number of components or *quality objectives* directly or indirectly affected by the unremediated *QC deficiencies*;
  - (2) The extent to which the unremediated *QC deficiencies* relate to a component, *quality objective*, or *quality response* that affects the design or operation of other components or *quality responses*;
  - (3) The number and pervasiveness of root causes underlying the unremediated *QC deficiencies*;
  - (4) The number of *engagements* that are affected by the unremediated *QC deficiencies* or are likely to be affected in the future if the *QC deficiencies* are not remediated;
  - (5) The number of *engagements* that may have unsupported opinions unless additional procedures are performed; and

- (6) The number of *engagements* for which the firm revised and reissued its engagement report(s) because, after additional procedures were performed, the financial statements or management’s report on internal control over financial reporting was restated or revised; and

Note: In evaluating each unremediated *QC deficiency*, the firm would consider both quantitative and qualitative implications.

- b. The extent to which remedial actions have been implemented, tested, and found to be effective.

### Reporting to the PCAOB

.79 The firm must report annually to the PCAOB on Form QC, in accordance with the instructions to that form, the results of the evaluation of its QC system not later than January 15 of the year following the evaluation date.

.80 The contents of the firm’s reporting to the PCAOB must include the following:

- a. The firm’s conclusion that, as of the evaluation date, the firm’s QC system:

- (1) Is effective with no unremediated *QC deficiencies*;
- (2) Is effective, except for one or more unremediated *QC deficiencies* that are not *major QC deficiencies*; or
- (3) Is not effective (one or more *major QC deficiencies* exists).

- b. If the firm reports a conclusion under .80a.(2) or .80a.(3), a description of each unremediated *QC deficiency*, including each *major QC deficiency*, consisting of:

- (1) The requirements of this standard or the *quality objective(s)* to which it relates;
- (2) The firm’s basis for determining it was a *QC deficiency* as of the evaluation date; and
- (3) A summary of the remedial actions taken and planned to be taken to address the *QC deficiency*, as well as the timing and the status of such actions, including a summary of actions taken or to be taken by the firm to address the risk that the *QC deficiency* resulted or could result in the issuance of unsupported engagement reports.

- c. If a *major QC deficiency* is presumed to exist but the determination was made that there is no *major QC deficiency*, the basis for such determination.

## Documentation

- .81 The firm must prepare and retain documentation of the design, implementation, and operation of the QC system and of the annual evaluation of the QC system.
- .82 Documentation must include descriptions of the following matters:
- a. Lines of responsibility and supervision within the firm’s QC system at successive senior levels up to and including the principal executive officer(s) or equivalent.
  - b. Regarding the firm’s risk assessment process:
    - (1) *Quality objectives*;
    - (2) *Quality risks* related to the established *quality objectives* and the basis for the assessment of *quality risks*; and
    - (3) *Quality responses* and how the firm’s *quality responses* are designed to address the *quality risks*.
  - c. Regarding the monitoring and remediation process:
    - (1) The *engagement* and QC system-level monitoring activities performed, including, if applicable, monitoring activities performed by the network;
    - (2) If a firm determines an *engagement deficiency* exists but that there is sufficient appropriate audit evidence to support the auditor’s opinion, the basis to support the firm’s determination;
    - (3) Actions taken to address *engagement deficiencies* pursuant to paragraphs .68 and .69;<sup>47</sup>
    - (4) The evaluation of *QC findings* to determine whether *QC deficiencies* exist and the basis for each determination;<sup>48</sup> and

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<sup>47</sup> See AS 1215.16 for documentation requirements regarding actions taken to address *engagement deficiencies* on completed audit *engagements*.

<sup>48</sup> See QC 1000.72.

- (5) Root cause analysis and remedial actions to address identified *QC deficiencies* and the monitoring activities performed to evaluate the implementation and operating effectiveness of such remedial actions.<sup>49</sup>
- d. Regarding the evaluation of the firm’s QC system, the basis for the conclusion reached pursuant to paragraph .77.
- e. If the firm belongs to a network that provides or requires the use of resources or services in the firm’s QC system or the performance of the firm’s *engagements*, or uses resources or services obtained from a *third-party provider*:
- (1) The firm’s understanding of how the resources or services used by the firm are developed and maintained;
  - (2) If the firm supplemented or adapted such resources or services, how and why they were supplemented or adapted; and
  - (3) How the firm implemented and operated such resources or services.
- .83 The documentation must be in sufficient detail to:
- a. Support a consistent understanding of the QC system by *firm personnel*, including an understanding of their roles and responsibilities with respect to the firm’s QC system; and
  - b. Enable an experienced auditor that understands QC systems, but has no experience with the design, implementation, and operation of the firm’s QC system, to understand how the firm has designed, implemented, and operated the QC system to achieve the reasonable assurance objective, including the *quality objectives*, *quality risks*, *quality responses*, monitoring activities, remedial actions, and basis for the conclusions reached in the evaluation of the QC system.
- .84 A complete and final set of documentation as required by paragraphs .81-.83 with respect to the 12-month period ending the prior November 30 and any evaluation required as of that date should be assembled for retention as of January 15 (“QC documentation completion date”).
- .85 Circumstances may require additions to documentation after the QC documentation completion date. Documentation must not be deleted or discarded after the QC documentation completion date; however, information may be added. Any documentation added must

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<sup>49</sup> See QC 1000.73-.76.

indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it.

.86 The firm must retain documentation of its QC system for seven years from the QC documentation completion date, unless a longer period of time is required by law.

## APPENDIX A – Definitions

- .A1 For purposes of this standard, the terms listed below are defined as follows:
- .A2 Applicable professional and legal requirements –
- (1) Professional standards, as defined in PCAOB Rule 1001(p)(vi);
  - (2) Rules of the PCAOB that are not professional standards; and
  - (3) To the extent related to the obligations and responsibilities of accountants or auditors or to the conduct of *engagements*, rules of the SEC, other provisions of U.S. federal securities law, and other applicable statutory, regulatory, and other legal requirements.
- .A3 Engagement –
- (1) Any audit, attestation, review, or other engagement under PCAOB standards performed by a firm; or
  - (2) Any engagement in which a firm “play[s] a substantial role in the preparation or furnishing of an audit report” as defined in PCAOB Rule 1001(p)(ii).
- .A4 Engagement deficiency – An instance of noncompliance with *applicable professional and legal requirements* by the firm, *firm personnel*, or *other participants* with respect to an *engagement* of the firm, or by the firm or *firm personnel* with respect to an *engagement* of another firm.
- .A5 Firm personnel – Individual proprietors, partners, shareholders, members or other principals, accountants, and professional staff of a registered public accounting firm whose responsibilities include assisting with:
- (1) The performance of the firm’s *engagements*; or
  - (2) The design, implementation, or operation of the firm’s QC system, including engagement quality reviews.
- Professional staff includes employees as well as individuals, such as non-employee contractors and consultants, who work under the firm’s supervision or direction and control and function as the firm’s employees. These individuals include, for example, secondees and leased staff who work under the supervision or direction and control of the firm.
- .A6 Major QC deficiency – An unremediated *QC deficiency* or combination of unremediated *QC deficiencies*, based on the evaluation under paragraph .78, that severely reduces the

likelihood of the firm achieving the reasonable assurance objective or one or more *quality objectives*.

A *major QC deficiency* would be presumed to exist if there is:

- (1) An unremediated *QC deficiency* or combination of unremediated *QC deficiencies*
- (2) That:
  - (a) Relates to the firm’s governance and leadership that affect the overall environment supporting the operation of the QC system; or
  - (b) Results in or is likely to result in one or more significant engagement deficiencies<sup>1</sup> in *engagements* that, taken together, are significant in relation to the firm’s total portfolio of *engagements* (for example, because of the number of *engagements* or *firm personnel* affected or likely to be affected, the associated revenue or profit, the associated risks, or the relevant industry).

.A7 Other participants – With respect to work performed in connection with the firm’s QC system or the performance of its *engagements*, *other participants* are accounting firms (foreign or domestic, registered or non-registered), accountants, and other professionals or organizations, other than *firm personnel*, whose responsibilities include assisting with:

- (1) The performance of the firm’s *engagements*; or
- (2) The design, implementation, or operation of the firm’s QC system, including engagement quality reviews.

.A8 QC deficiency – A *QC finding* that, based on the evaluation under paragraph .72, individually or in combination with one or more other *QC findings*, results in:

- (1) A reduced likelihood of the firm achieving the reasonable assurance objective or one or more *quality objectives*;

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<sup>1</sup> A significant engagement deficiency exists when (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB or failed to perform interim review or attestation procedures necessary in the circumstances, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client. See, e.g., Notes to AS 1220.12, .17, .18B.

Note: The likelihood could be reduced if, for example, a *quality objective* is not established, a *quality risk* is not properly identified or assessed, or a *quality response* is not properly designed or implemented or is not operating effectively.

- (2) Noncompliance with requirements of this standard, other than those under “Documentation”; or
- (3) Noncompliance with requirements of this standard under “Documentation” that adversely affects the firm’s ability to comply with any of the other requirements of this standard.

.A9 QC finding – A finding about the design, implementation, or operation of the firm’s QC system that may indicate one or more *QC deficiencies* exist. *Engagement deficiencies* are *QC findings*.

.A10 Quality objectives – The desired outcomes in relation to the components of the QC system to be achieved by the firm.

.A11 Quality responses – Policies and procedures designed and implemented by the firm to address *quality risks*:

- (1) Policies are statements of what should, or should not, be done to address an assessed *quality risk*. Such statements may be documented or explicitly stated in communications.
- (2) Procedures are actions to implement and comply with policies.

.A12 Quality risks – Risks that, individually or in combination with other risks, have a reasonable possibility of adversely affecting the firm’s achievement of one or more *quality objectives* if the risks were to occur, and are either:

- (1) Risks that have a reasonable possibility of occurring; or
- (2) Risks of intentional acts by *firm personnel* and *other participants* to deceive or to violate *applicable professional and legal requirements*.

.A13 Third-party providers – Individuals or organizations, other than *other participants*, that provide resources or services to the firm that are designed specifically for use in the performance of *engagements* (e.g., purchased methodologies, related templates, and IT applications) or to assist with the operation of its QC system (e.g., broker and dealer monitoring systems to track personal financial interests of *firm personnel*).

## APPENDIX B – Examples Relevant to Obtaining an Understanding of the Nature and Circumstances of the Firm and its Engagements

.B1 This appendix provides examples related to paragraphs .20a.(1) and .20a.(2). Whether a particular example is relevant, whether it results in one or more *quality risks*, or how it affects the assessment of *quality risks* will depend upon the nature and circumstances of the firm and its *engagements*.

.B2 *The complexity and operating characteristics of the firm* (.20a.(1)(a)). This includes the size of the firm, the geographical distribution of the firm’s operations, how the firm is structured, and the extent to which the firm concentrates or centralizes its processes or activities. Examples include:

- a. Complexity of the organizational structure, including the number of managerial levels;
- b. Structure of reporting lines, including overlapping or interconnected reporting lines;
- c. Centralized or decentralized nature of the firm;
- d. Changes in firm structure (e.g., reorganizations, mergers and acquisitions, or divestitures);
- e. Internal or external factors limiting the availability or use of resources, including financial resources, for the firm’s QC system or its *engagements*;
- f. The nature and extent of use or involvement of shared service centers and whether these are internal or external to the firm; and
- g. The existence and extent of governance structures providing oversight of leadership.

.B3 *The firm’s business processes and strategic and operational decisions and actions* (.20a.(1)(b)). This includes decisions about financial and operational matters, including the firm’s strategic goals. Examples include:

- a. Pressure to meet financial targets and commercial goals that could affect resource availability or other aspects of the firm’s QC system;
- b. Changes in firm business strategy or goals affecting the firm’s audit practice; and
- c. Mergers, acquisitions, and divestitures.

.B4 *The characteristics and management style of leadership* (.20a.(1)(c)). This includes the composition of firm leadership, leadership tenure, distribution of authority among leadership, and how leadership motivates and encourages *firm personnel*. Examples include:

- a. Changes in firm leadership (e.g., senior leadership turnover);
- b. The extent to which senior leadership consists of individuals without experience in auditing;
- c. Highly concentrated or distributed management authority, particularly for the size of the firm;
- d. Leadership tone or conduct;
- e. Actions or inactions that result in a history of recurring *QC deficiencies* or *engagement deficiencies* (regardless of whether identified internally or externally);
- f. Timing of actions in response to identified *QC deficiencies* or *engagement deficiencies*;
- g. The extent to which *firm personnel* are held accountable for violations of *applicable professional and legal requirements* or of the firm's policies and procedures; and
- h. The extent of focus on commercial goals compared to the quality of the firm's engagements.

.B5 *The resources of the firm* (.20a.(1)(d)). This includes people, financial, technological, and intellectual resources and the characteristics and availability of such resources. Examples include:

- a. Availability of skilled individuals;
- b. Availability of financial, technological, and intellectual resources;
- c. Highly centralized or decentralized environments to manage resources;
- d. Dependency on, and complexity of, technology used by the firm;
- e. The firm's ability to obtain and use technological resources in performing *engagements* that are commensurate with the technology risk profiles of the firm's clients; and
- f. Nature of technology development and resources to maintain the technology (e.g., in-house versus purchased).

.B6 *The environment in which the firm operates, including applicable professional and legal requirements* (.20a.(1)(e)). This includes economic stability; social and technological factors; laws and regulations directly relevant to the firm; and *applicable professional and legal requirements* affecting engagements performed by the firm. Examples include:

- a. Changes to the external environment (e.g., economic, political, or technological) affecting the firm and its QC system;
- b. Economic conditions or other external factors limiting the availability of resources; and
- c. Changes to *applicable professional and legal requirements* relevant to the firm, including its QC system and *firm personnel*.

.B7 *If the firm belongs to a network, the characteristics of the network and the network's resources and services and the nature and extent of resources and services used by the firm* (.20a.(1)(f)). This includes the nature of the network, the nature and extent of the requirements established by the network, and the resources and services provided by the network. Examples include:

- a. How the network is organized and operates;
- b. The extent and frequency of communication from the network to the firm related to resources and services provided by the network;
- c. The extent to which network requirements or network services are or should be supplemented or adapted for the firm's use;
- d. The process used to develop technological and intellectual resources provided by the network; and
- e. Observations from monitoring activities regarding the design of network resources and services and their use by the firm.

.B8 *If the firm uses other participants, the nature and extent of their involvement* (.20a.(1)(g)). This includes the types of and extent to which the firm uses *other participants* and the characteristics of such *other participants*. Examples include:

- a. The extent of reliance by the firm on *other participants*;
- b. Information regarding the reliability and quality of the services performed and the experience and competence of the individuals performing those services; and
- c. Whether the *other participants* belong to the same network as the firm.

.B9 *If the firm participates in other firms' engagements, the nature and extent of the firm's participation (.20a.(1)(h)).* This includes the nature of the procedures performed, the extent of participation, and other characteristics, including characteristics of the other firms. Examples include:

- a. The type of work performed by the firm on the other firms' *engagements*;
- b. The extent of participation in the other firms' *engagements*;
- c. Prior experience in participating in the other firms' *engagements*; and
- d. The reputation of the other firms.

.B10 *If the firm uses resources or services obtained from third-party providers, the nature and extent of those resources or services (.20a.(1)(i)).* This includes the types of and extent to which the firm uses *third-party providers* and the characteristics of such *third-party providers*. Examples include:

- a. The extent of usage by the firm of *third-party providers*;
- b. The extent of alignment of the *third-party providers'* standards of conduct with those of the firm;
- c. Observations from monitoring activities regarding the design of the services performed and their use by the firm; and
- d. Information regarding the experience, reliability, and quality of the services performed and the experience and competence of the individuals performing those services.

.B11 *The nature and circumstances of the firm's engagements (.20a.(2)).* This includes the types of *engagements* performed by the firm and the types of companies for which such *engagements* are undertaken. Examples include:

- a. Size, industry, complexity, and risk profile of the companies for which the firm's *engagements* are performed, including the potential need for external resources (e.g., specialists, valuation reports, analyst or short-seller reports);
- b. Complexity of or changes to *applicable professional and legal requirements* and the firm's policies and procedures relevant to the firm's *engagements*;
- c. The extent of the firm's and its personnel's experience with the relevant types of *engagements* (e.g., audits of internal control over financial reporting or attestation *engagements* of brokers and dealers) or industries;

- d. Complexity of technology used by clients and used by the firm when performing *engagements*;
- e. Changes in the external environment affecting the firm's *engagements*;
- f. Impediments to the firm's ability to perform the required *engagement* procedures, whether due to lack of available evidence or otherwise; and
- g. Information obtained from external inspections or reviews and oversight activities by regulators.

## APPENDIX 2 – PROPOSED REPORTING RULE AND FORM QC

Language that would be deleted by the proposed amendments is ~~struck through~~.  
Language that would be added is underlined.

### Rule 2203A. Report on the Evaluation of the Firm’s System of Quality Control

If a registered public accounting firm is required to perform an evaluation of its QC system under paragraph .77 of QC 1000, *A Firm’s System of Quality Control*, the firm must file with the Board a report on such evaluation on Form QC, by following the instructions to that form. Unless directed otherwise by the Board, the registered public accounting firm must file such report and exhibits thereto electronically with the Board through the Board’s Web-based system no later than January 15 following the relevant “evaluation date” (as defined in QC 1000.77). The Board will not make a filed Form QC or the contents thereof (including any amendments thereto) public; provided, however, that nothing in this Rule forecloses the disclosure of Form QC or its contents in an enforcement proceeding. The Board may publish such summaries, compilations, or other general reports containing the contents of Form QC filings as the Board deems appropriate, provided that no such published report shall identify the firm or firms to which particular Form QC information relates unless that information has previously been made public by the firm or firms involved or by other lawful means.

Note: Pursuant to Rule 1002, in any year in which the filing deadline falls on a Saturday, Sunday, or federal legal holiday, the deadline for filing Form QC shall be the next day that is not a Saturday, Sunday, or federal legal holiday.

### Form QC: Report on the Evaluation of the Firm’s System of Quality Control

#### **GENERAL INSTRUCTIONS**

1. Submission of this Report. *A registered public accounting firm* that is required to perform an evaluation of its QC system under paragraph .77 of QC 1000, *A Firm’s System of Quality Control*, must use this Form to file with the *Board* the report on quality control required by QC 1000 and Rule 2203A and to file any amendments to Form QC. Unless otherwise directed by the *Board*, the Firm must file this Form, and all exhibits to this Form, electronically with the *Board* through the *Board’s* Web-based system.
2. Defined Terms. The definitions in the *Board’s rules* and in QC 1000 apply to this Form. Italicized terms in the instructions to this Form are defined in the *Board’s rules* or QC 1000, as the case may be. In addition, as used in the instructions to this Form, the term “the Firm” means the *registered public accounting firm* that is filing this Form with the *Board*.

3. When Report is Due and Considered Filed. Reports on this Form are required to be filed each year on or before January 15. A Form QC is considered filed when the Firm has submitted to the *Board* a Form QC in accordance with Rule 2203A that includes the signed certifications required in Parts III and V of Form QC.
4. Amendments to this Report. Amendments shall not be filed to update information in a filed Form QC that was correct at the time the Form was filed, but only to correct information that was incorrect at the time the Form was filed or to provide information that was omitted from the Form and was required to be provided at the time the Form was filed. When filing a Form QC to amend an earlier filed Form QC, the Firm must supply not only the corrected or supplemental information, but also must include in the amended Form QC all information and certifications that were required to be included in the original Form QC. The Firm may access the originally filed Form QC through the *Board's* Web-based system and make the appropriate amendments without needing to re-enter all other information.

Note: The *Board* will designate an amendment to a Form QC as a report on "Form QC/A."

5. Rules Governing this Report. In addition to these instructions, the rules in Part 2 of Section 2 of the *Board rules* govern this Form. Read these *rules* and the instructions carefully before completing this Form.
6. Language. Information submitted as part of this Form, including any exhibit to this Form, must be in the English language.

## **PART I – IDENTITY OF THE FIRM**

### Item 1.1 Name of the Firm

State the legal name of the Firm.

## **PART II – EVALUATION OF THE FIRM'S SYSTEM OF QUALITY CONTROL**

### Item 2.1 Evaluation Date

State the evaluation date of this report

### Item 2.2 Overall Conclusion on the Effectiveness

Indicate, by checking the applicable box, the Firm's conclusion on whether, as of the evaluation date, the Firm's QC system:

- a. Is effective with no unremediated *QC deficiencies*; or
- b. Is effective except for one or more unremediated *QC deficiencies* that are not *major QC deficiencies*; or
- c. Is not effective (one or more *major QC deficiencies* exists).

Item 2.3 Reporting on Unremediated *QC Deficiencies*

If the Firm reports a conclusion under Item 2.2b. or Item 2.2c. provide the number of unremediated *QC deficiencies*:

Item 2.4 Reporting on an Unremediated *QC Deficiency*

If the Firm reports a conclusion under Item 2.2b. or Item 2.2c., for each unremediated *QC deficiency* in Item 2.3:

- a. Provide a description of the unremediated *QC deficiency*.
- b. Indicate by checking the box whether the unremediated *QC deficiency* is:
  1. A *major QC deficiency*
  2. Not a *major QC deficiency*
- c. Indicate, by checking all boxes that apply, the area(s) the unremediated *QC deficiency* relates to:
  1. Roles and responsibilities
  2. The firm's risk assessment process
  3. Governance and leadership
  4. Ethics and independence
  5. Acceptance and continuance of client relationships and specific engagements
  6. Engagement performance

7. Resources
  8. Information and communication
  9. Monitoring and remediation process
  10. Evaluating and reporting on the QC system
  11. Documentation
- d. Furnish, as a correspondingly numbered item in Exhibit 2.4, the following:
1. The quality objective(s), or requirement(s) of QC 1000, to which the unremediated *QC deficiency* relates.
  2. The Firm's basis for determining it was a *QC deficiency* as of the evaluation date.
  3. A summary of the remedial actions taken and planned to be taken to address the *QC deficiency*, as well as the timing and the status of such actions, including a summary of the actions taken and to be taken by the Firm to address the risk that the *QC deficiency* resulted or could result in the issuance of unsupported opinions.

Item 2.5 Reporting on a Presumed *Major QC Deficiency*

If a *major QC deficiency* is presumed to exist, as described in the definition of *major QC deficiency* in QC 1000, but the determination was made that there is no *major QC deficiency*, furnish, as Exhibit 2.5, a narrative describing the basis for such determination.

**PART III – INDIVIDUAL(S) RESPONSIBLE FOR THE SYSTEM OF QUALITY CONTROL;  
CERTIFICATION**

Item 3.1 Identity of Individual(s) Responsible and Accountable for the System of Quality Control

State the name of the individual(s) assigned:

- a. Ultimate responsibility and accountability for the Firm's QC system as a whole.
- b. Operational responsibility and accountability for the QC system as a whole.

- c. Operational responsibility for compliance with ethics and independence requirements.
- d. Operational responsibility for monitoring and remediation.

### Item 3.2 Certification of the Report on the Annual Evaluation of the Firm's QC System

Furnish, as Exhibits 3.2.a and 3.2.b, respectively, statements signed by each of the individuals identified in Item 3.1.a and 3.1.b in the following form:

I, [identify the certifying individual], who have been assigned [ultimate/operational] responsibility and accountability for [Firm]'s quality control system (QC system) as a whole, certify that:

1. I have reviewed this report on Form QC on the evaluation of [Firm]'s quality control system (QC system) as of November 30, [year];
2. Based on my knowledge, the disclosures made [in Part II of] this form are complete and accurate in all material respects; and
3. [The Firm's other certifying officer(s) and] I [are/am] responsible and accountable for [Firm]'s QC system as a whole and have:
  - (a) Designed, or caused to be designed under [my/our] supervision, the Firm's QC system to ensure that it meets the reasonable assurance objective specified in QC 1000, *A Firm's System of Quality Control*;
  - (b) Evaluated the effectiveness of the Firm's QC system and presented in this report [my/our] conclusions about the effectiveness of the QC system as of November 30, [year]; and
  - (c) Disclosed, based on such evaluation, all unremediated QC deficiencies (as defined in QC 1000) of which I am aware.

Date:

[Signature]

[Title]

Note 1: Other than the insertion of the Firm name and the name and role of the signing individual, Exhibits 3.2.a and 3.2.b must be in the exact words contained in this instruction.

Note 2: If more than one individual is identified in Item 3.1.a, Exhibit 3.2.a must be signed by each such individual. If the same individual is identified in Items 3.1.a and 3.1.b, he or she may sign a single certificate indicating both capacities.

Note 3: Exhibits 3.2.a and 3.2.b may be provided in a form (e.g., pdf) that shows a manual signature, or may be signed and retained in the same manner as provided in Rule 2204.

#### **PART IV – REQUEST FOR NOTIFICATION**

##### Item 4.1 Request for Notification

Indicate, by checking the box below, whether the Firm requests the *Board* to notify the firm in the event that the *Board* is requested by subpoena or other legal process to disclose information on the Firm's Form QC. The *Board* will make reasonable attempts to honor such request.

Yes

No

#### **PART V – CERTIFICATION OF THE FIRM**

##### Item 5.1 Signature of Partner or Authorized Officer

This Form must be signed on behalf of the Firm by an authorized partner or officer of the Firm including, in accordance with Rule 2204, both a signature that appears in typed form within the electronic submission and a corresponding manual signature retained by the Firm. The signer must certify that –

- a. the signer is authorized to sign this Form on behalf of the Firm;
- b. the signer has reviewed this Form;
- c. based on the signer's knowledge, this Form does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading; and
- d. based on the signer's knowledge, the Firm has not failed to include in this Form any information or affirmation that is required by the instructions to this Form.

The signature must be accompanied by the signer's title, the capacity in which the signer signed the Form, the date of signature, and the signer's business mailing address, business telephone number, and business email address.

## **PART VI – AMENDMENTS**

### **Item 6.1 Amendments**

If this is an amendment to a report previously filed with the *Board* -

- a. Indicate, by checking the box corresponding to this item, that this is an amendment.
- b. Identify the specific Item numbers of this Form (other than this Item 6.1) as to which the Firm's response has changed from that provided in the most recent Form QC or amended Form QC filed by the Firm with respect to the reporting period.

## **PART VII – EXHIBITS**

To the extent applicable under the foregoing instructions or the *Board's rules*, each Form QC must be accompanied by the following exhibits:

Exhibit 2.4 Reporting on an Unremediated *QC Deficiency* in Item 2.4.1

Exhibit 2.5 Reporting on a Presumed *Major QC Deficiency* in Item 2.5

Exhibit 3.2.a Certification of the Report on the Annual Evaluation of the Firm's QC system by the individual(s) assigned ultimate responsibility and accountability for the Firm's QC system as a whole

Exhibit 3.2.b Certification of the Report on the Annual Evaluation of the Firm's QC system by the individual with operational responsibility and accountability for the Firm's QC system as a whole

Note: Where an exhibit consists of more than one document, each document must be numbered consecutively (e.g., Exhibit 3.2.a.1, Exhibit 3.2.a.2, etc.), and the firm must provide a list of the title or description of each document comprising the exhibit.

## APPENDIX 3 – PROPOSED AMENDMENTS TO AS 2901

Language that would be deleted by the proposed amendments to AS 2901 is ~~struck through~~. Language that would be added is underlined.

### ~~AS 2901: Consideration of Omitted Procedures After the Report Date~~

~~.01— This section provides guidance on the considerations and procedures to be applied by an auditor who, subsequent to the date of his report on audited financial statements, concludes that one or more auditing procedures considered necessary at the time of the audit in the circumstances then existing were omitted from his audit of the financial statements, but there is no indication that those financial statements are not fairly presented in conformity with generally accepted accounting principles or with another comprehensive basis of accounting.<sup>1</sup> This circumstance should be distinguished from that described in AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, which applies if an auditor, subsequent to the date of his report on audited financial statements, becomes aware that facts regarding those financial statements may have existed at that date that might have affected his report had he then been aware of them.~~

~~.02— Once he has reported on audited financial statements, an auditor has no responsibility to carry out any retrospective review of his work. However, reports and working papers relating to particular engagements may be subjected to post-issuance review in connection with a firm's internal inspection program,<sup>2</sup> peer review, or otherwise, and the omission of a necessary auditing procedure may be disclosed.~~

~~.03— A variety of conditions might be encountered in which an auditing procedure considered necessary at the time of the audit in the circumstances then existing has been omitted; therefore, the considerations and procedures described herein necessarily are set forth only in general terms. The period of time during which the auditor considers whether this section applies to the circumstances of a particular engagement and then takes the actions, if any, that are required hereunder may be important. Because of legal implications that may be involved in taking the actions contemplated herein, the auditor would be well advised to consult with his attorney when he encounters the circumstances to which this section may apply, and, with the attorney's advice and assistance, determine an appropriate course of action.~~

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<sup>1</sup>— The provisions of this section are not intended to apply to an engagement in which an auditor's work is at issue in a threatened or pending legal proceeding or regulatory investigation. (A *threatened legal proceeding* means that a potential claimant has manifested to the auditor an awareness of, and present intention to assert, a possible claim.)

<sup>2</sup>— See paragraph .02 of AS 1110, *Relationship of Auditing Standards to Quality Control Standards*, and related quality control standards regarding the quality control function of inspection.

~~.04 — When the auditor concludes that an auditing procedure considered necessary at the time of the audit in the circumstances then existing was omitted from his audit of financial statements, he should assess the importance of the omitted procedure to his present ability to support his previously expressed opinion regarding those financial statements taken as a whole. A review of his working papers, discussion of the circumstances with engagement personnel and others, and a re-evaluation of the overall scope of his audit may be helpful in making this assessment. For example, the results of other procedures that were applied may tend to compensate for the one omitted or make its omission less important. Also, subsequent audits may provide audit evidence in support of the previously expressed opinion.~~

~~.05 — If the auditor concludes that the omission of a procedure considered necessary at the time of the audit in the circumstances then existing impairs his present ability to support his previously expressed opinion regarding the financial statements taken as a whole, and he believes there are persons currently relying, or likely to rely, on his report, he should promptly undertake to apply the omitted procedure or alternative procedures that would provide a satisfactory basis for his opinion.~~

~~.06 — When as a result of the subsequent application of the omitted procedure or alternative procedures, the auditor becomes aware that facts regarding the financial statements existed at the date of his report that would have affected that report had he been aware of them, he should be guided by the provisions of AS 2905.05-.09.~~

~~.07 — If in the circumstances described in paragraph .05, the auditor is unable to apply the previously omitted procedure or alternative procedures, he should consult his attorney to determine an appropriate course of action concerning his responsibilities to his client, regulatory authorities, if any, having jurisdiction over the client, and persons relying, or likely to rely, on his report.~~

#### ~~Effective Date~~

~~.08 — This section is effective as of October 31, 1983.~~

## AS 2901: Responding to Engagement Deficiencies After Issuance of the Auditor’s Report

### **Introduction**

.01 This standard applies when, after issuance of an auditor’s report, an engagement deficiency<sup>1</sup> is identified<sup>2</sup> on an audit of financial statements or internal control over financial reporting, unless it is probable<sup>3</sup> that the auditor’s report is not being relied upon.

Note 1: The firm must treat as relied upon any auditor’s report that is included in the most recent filing on an SEC form that requires inclusion of such an auditor’s report.

Note 2: AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report*, and paragraph .98 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, may also apply in these circumstances.

### **Objective**

.02 The objective of the auditor is to take appropriate action to respond to identified engagement deficiencies.

### **Responding to the Engagement Deficiency**

.03 For engagement deficiencies where the auditor did not obtain sufficient appropriate audit evidence to support the auditor’s opinion, the auditor should:

- a. Perform procedures to obtain additional evidence, to the extent necessary, such that the opinion is supported by sufficient appropriate evidence; or
- b. Take action to prevent future reliance on the report in the manner specified in paragraphs .06-.09 of AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report*.

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<sup>1</sup> “Engagement deficiency” is defined in QC 1000, *A Firm’s System of Quality Control*, Appendix A—Definitions.

<sup>2</sup> See paragraph .67 of QC 1000 on determining when an engagement deficiency exists.

<sup>3</sup> The term “probable” has the same meaning as used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

.04 For other engagement deficiencies, the auditor should take action to address the deficiency, taking into account the nature and severity of the deficiency.

Note: Remedial actions a firm may take include: (1) corrective actions to address engagement deficiencies on completed engagements; and (2) preventive actions to deter future engagement deficiencies.

### **Documentation**

.05 The auditor should comply with:

- a. Paragraph .16 of AS 1215, *Audit Documentation*, when documenting its response to engagement deficiencies within the working papers; and
- b. QC 1000.82c. when documenting the actions taken to address engagement deficiencies as part of the monitoring and remediation process of its QC system.

## APPENDIX 4 – RESCISSION OF ET SECTION 102; PROPOSED EI 1000; AMENDMENTS TO ET SECTION 191

Language that would be rescinded is ~~struck through~~. Proposed language that would be added is underlined.

### ~~ET Section 102, Integrity and Objectivity~~

#### ~~.01~~

~~**Rule 102 – Integrity and objectivity.** In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.~~

#### ~~Interpretations Under Rule 102 – Integrity and Objectivity~~

#### ~~.02~~

~~**102-1 – Knowing misrepresentations in the preparation of financial statements or records.** A member shall be considered to have knowingly misrepresented facts in violation of rule 102 [ET section 102.01] when he or she knowingly —~~

- ~~a. — Makes, or permits or directs another to make, materially false and misleading entries in an entity’s financial statements or records; or~~
- ~~b. — Fails to correct an entity’s financial statements or records that are materially false and misleading when he or she has the authority to record an entry; or~~
- ~~c. — Signs, or permits or directs another to sign, a document containing materially false and misleading information.~~

#### ~~.03~~

~~**102-2 – Conflicts of interest.** A conflict of interest may occur if a member performs a professional service for a client or employer and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, the rule shall not operate to prohibit the performance of the professional service. When making the disclosure, the member should consider Rule 301, Confidential Client Information [ET section 301.01].~~

~~Certain professional engagements, such as audits, reviews, and other attest services, require independence. Independence impairments under rule 101 [ET section 101.01], its interpretations, and rulings cannot be eliminated by such disclosure and consent.~~

~~The following are examples, not all inclusive, of situations that should cause a member to consider whether or not the client, employer, or other appropriate parties could view the relationship as impairing the member's objectivity:~~

- ~~▪ A member has been asked to perform litigation services for the plaintiff in connection with a lawsuit filed against a client of the member's firm.~~
- ~~▪ A member has provided tax or personal financial planning (PFP) services for a married couple who are undergoing a divorce, and the member has been asked to provide the services for both parties during the divorce proceedings.~~
- ~~▪ In connection with a PFP engagement, a member plans to suggest that the client invest in a business in which he or she has a financial interest.~~
- ~~▪ A member provides tax or PFP services for several members of a family who may have opposing interests.~~
- ~~▪ A member has a significant financial interest, is a member of management, or is in a position of influence in a company that is a major competitor of a client for which the member performs management consulting services.~~
- ~~▪ A member serves on a city's board of tax appeals, which considers matters involving several of the member's tax clients.~~
- ~~▪ A member has been approached to provide services in connection with the purchase of real estate from a client of the member's firm.~~
- ~~▪ A member refers a PFP or tax client to an insurance broker or other service provider, which refers clients to the member under an exclusive arrangement to do so.~~
- ~~▪ A member recommends or refers a client to a service bureau in which the member or partner(s) in the member's firm hold material financial interest(s).~~

~~The above examples are not intended to be all-inclusive.~~

~~.04~~

~~**102-3—Obligations of a member to his or her employer's external accountant.** Under rule 102 [ET section 102.01], a member must maintain objectivity and integrity in the performance of a~~

~~professional service. In dealing with his or her employer's external accountant, a member must be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts. This would include, for example, responding to specific inquiries for which his or her employer's external accountant requests written representation.~~

~~.05~~

~~**102-4—Subordination of judgment by a member.** Rule 102 [ET section 102.01] prohibits a member from knowingly misrepresenting facts or subordinating his or her judgment when performing professional services. Under this rule, if a member and his or her supervisor have a disagreement or dispute relating to the preparation of financial statements or the recording of transactions, the member should take the following steps to ensure that the situation does not constitute a subordination of judgment:<sup>fn-1</sup>~~

- ~~1. The member should consider whether (a) the entry or the failure to record a transaction in the records, or (b) the financial statement presentation or the nature or omission of disclosure in the financial statements, as proposed by the supervisor, represents the use of an acceptable alternative and does not materially misrepresent the facts. If, after appropriate research or consultation, the member concludes that the matter has authoritative support and/or does not result in a material misrepresentation, the member need do nothing further.~~
- ~~2. If the member concludes that the financial statements or records could be materially misstated, the member should make his or her concerns known to the appropriate higher level(s) of management within the organization (for example, the supervisor's immediate superior, senior management, the audit committee or equivalent, the board of directors, the company's owners). The member should consider documenting his or her understanding of the facts, the accounting principles involved, the application of those principles to the facts, and the parties with whom these matters were discussed.~~
- ~~3. If, after discussing his or her concerns with the appropriate person(s) in the organization, the member concludes that appropriate action was not taken, he or she should consider his or her continuing relationship with the employer. The member also should consider any responsibility that may exist to communicate to third parties, such as regulatory authorities or the employer's (former employer's) external accountant. In this connection, the member may wish to consult with his or her legal counsel.~~
- ~~4. The member should at all times be cognizant of his or her obligations under interpretation 102-3 [ET section 102.04].~~

~~.06~~

~~**102-5—Applicability of rule 102 to members performing educational services.** Educational services (for example, teaching full or part time at a university, teaching a continuing professional education course, or engaging in research and scholarship) are professional services as defined in ET section 92.11, and are therefore subject to rule 102 [ET section 102.01]. Rule 102 [ET section 102.01] provides that the member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.~~

~~.07~~

~~**102-6—Professional services involving client advocacy.** A member or a member's firm may be requested by a client—~~

- ~~1. — To perform tax or consulting services engagements that involve acting as an advocate for the client.~~
- ~~2. — To act as an advocate in support of the client's position on accounting or financial reporting issues, either within the firm or outside the firm with standard setters, regulators, or others.~~

~~Services provided or actions taken pursuant to such types of client requests are professional services [ET section 92.11] governed by the Code of Professional Conduct and shall be performed in compliance with Rule 201, General Standards [ET section 201.01], Rule 202, Compliance With Standards [ET section 202.01], and Rule 203, Accounting Principles [ET section 203.01], and interpretations thereof, as applicable. Furthermore, in the performance of any professional service, a member shall comply with rule 102 [ET section 102.01], which requires maintaining objectivity and integrity and prohibits subordination of judgment to others. When performing professional services requiring independence, a member shall also comply with rule 101 [ET section 101.01] of the Code of Professional Conduct.~~

~~Moreover, there is a possibility that some requested professional services involving client advocacy may appear to stretch the bounds of performance standards, may go beyond sound and reasonable professional practice, or may compromise credibility, and thereby pose an unacceptable risk of impairing the reputation of the member and his or her firm with respect to independence, integrity, and objectivity. In such circumstances, the member and the member's firm should consider whether it is appropriate to perform the service.~~

~~<sup>FR-1</sup> See paragraph .05b of AS 1201, Supervision of the Audit Engagement, and paragraph .12d of AS 1215, Audit Documentation.~~

## EI 1000, Integrity and Objectivity

.01 In connection with their responsibilities under applicable professional and legal requirements<sup>1</sup> and the firm’s policies and procedures related thereto (for example, training activities and other professional development; engagement planning, performance, and supervision; and communication with clients, other firm personnel, and regulators), a registered public accounting firm (“firm”) and its associated persons must maintain integrity and objectivity.

.02 Integrity includes:

- a. Being honest and candid.
- b. Not knowingly or recklessly misrepresenting facts. Misrepresenting facts includes knowingly or recklessly making, or permitting or directing another to make, materially false or misleading statements, including knowingly or recklessly (1) signing, or permitting or directing another to sign, a document containing materially false or misleading information and (2) failing to correct a document that is materially false and misleading when having the authority to do so.
- c. Not subordinating professional judgment. If a person associated with a registered firm and such person’s supervisor have a disagreement or dispute over applicable professional and legal requirements or how to apply or comply with them, the associated person should take the following steps to ensure that the situation does not constitute a subordination of judgment:
  - (1) Consider whether the supervisor’s approach results in a violation of applicable professional and legal requirements.
  - (2) If, after appropriate research or consultation, the associated person concludes that the supervisor’s approach has sufficient support under applicable professional and legal requirements or does not constitute such a violation, the person need do nothing further.
  - (3) If, after appropriate research or consultation, the associated person concludes that there is insufficient support under applicable professional and legal requirements and the supervisor’s approach could constitute a violation of applicable professional and legal requirements, the associated person should make their concerns known to the appropriate higher level(s) of management (for example, the supervisor’s immediate superior or senior management). The associated person should also consider documenting their understanding of the facts, the applicable professional and legal requirements involved, the

application of those requirements to the facts, and the parties involved in any relevant consultation or discussion.

(4) If appropriate action is not taken, the associated person should consider:

- (a) Potential responsibilities to notify third parties (e.g., regulatory authorities, audit committees); and
- (b) The appropriateness of maintaining a continuing relationship with the firm.

.03 Objectivity includes:

- a. Being impartial.
- b. Being intellectually honest.
- c. Being free of conflicts of interest. A conflict of interest arises if a firm or any of its associated persons has a relationship with another person, entity, or service that may reasonably be thought to bear on the ability of the firm or the associated person to exercise objective and impartial judgment in connection with their responsibilities under applicable professional and legal requirements with respect to an engagement not involving such other person, entity, or service.
  - (1) In general, if the firm believes that the firm and its associated persons can perform their respective responsibilities under applicable professional and legal requirements with objectivity, and the relationship is disclosed to and approval is obtained from the audit committee,<sup>2</sup> this standard does not prohibit the performance of the engagement.
  - (2) Independence violations, as determined under applicable professional and legal requirements, cannot be eliminated by such disclosure and approval.

<sup>1</sup> The term “applicable professional and legal requirements” is used as defined in paragraph .A2 of QC 1000, *A Firm’s System of Quality Control*.

<sup>2</sup> The term “audit committee” is used as defined in paragraph .A2 of AS 1301, *Communications with Audit Committees*.

## ET Section 191 – Ethics Rulings on Independence, Integrity, and Objectivity

\* \* \*

### **31. Performance of Services for Common Interest Realty Associations (CIRAs), Including Cooperatives, Condominium Associations, Planned Unit Developments, Homeowners Associations, and Timeshare Developments**

\* \* \*

#### **.062**

*Answer*—Independence would be considered to be impaired if a *covered* member was a member of a CIRA unless all of the following conditions are met:

\* \* \*

~~If the member has a relationship with a real estate developer or management company that is associated with the CIRA, see interpretation 102-2 [ET section 102.03] for guidance.~~

\* \* \*

### **[65.] Use of the CPA Designation by Member Not in Public Practice**

[Paragraphs .130-.131 deleted.]

#### ~~**.130**~~

~~*Question*—A member who is not in public practice wishes to use his or her CPA designation in connection with financial statements and correspondence of the member’s employer. The member also wants to use the CPA designation along with employment title on business cards. Is it permissible for the member to use the CPA designation in these manners?~~

#### ~~**.131**~~

~~*Answer*—Yes. However, if the member uses the CPA designation in a manner to imply that he or she is independent of the employer, the member would be knowingly misrepresenting facts in violation of rule 102 [ET section 102.01]. Therefore, it is advisable that in any transmittal within which the member uses his or her CPA designation, he or she clearly indicate the employment title. In addition, if the member states affirmatively in any transmittal that a financial statement is presented in conformity with generally accepted accounting principles, the member is subject to rule 203 [ET section 203.01].~~

~~[Replaces previous ruling No. 65, *Use of the CPA Designation by Member Not in Public Practice*, February 1996, effective February 29, 1996.]~~

\* \* \*

## [85.] Bank Director

[Paragraphs .170-.171 deleted.]

### ~~.170~~

~~Question—May a member in public practice serve as a director of a bank?~~

### ~~.171~~

~~Answer—Yes; however, before accepting a bank directorship, the member should carefully consider the implications of such service if the member has clients that are customers of the bank.~~

These implications fall into two categories:

- ~~a. Confidential Client Information—Rule 301 [ET section 301.01] provides that a member in public practice shall not disclose any confidential client information without the specific consent of the client. This ethical requirement applies even though failure to disclose information may constitute a breach of the member's fiduciary responsibility as a director.~~
- ~~b. Conflicts of Interest—Interpretation 102-2 [ET section 102.03] provides that a conflict of interest may occur if a member performs a professional service (including service as a director) and the member or his or her firm has a relationship with another entity that could, in the member's professional judgment, be viewed by appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity and the relationship is disclosed to and consent is obtained from all appropriate parties, performance of the service shall not be prohibited.~~

~~In view of the above factors, it is generally not desirable for a member in public practice to accept a position as bank director where the member's clients are likely to engage in significant transactions with the bank. If a member is engaged in public practice, the member should avoid the high probability of a conflict of interest and the appearance that the member's fiduciary obligations and responsibilities to the bank may conflict with or interfere with the member's ability to serve the client's interest objectively and in complete confidence.~~

~~The general knowledge and experience of CPAs in public practice may be very helpful to a bank in formulating policy matters and making business decisions; however, in most instances, it would be more appropriate for the member as part of the member's public practice to serve as~~

~~a consultant to the bank's board. Under such an arrangement, the member could limit activities to those which did not involve conflicts of interest or confidentiality problems.~~

~~\* \* \*~~

### **[93.] Service on Board of Directors of Federated Fund-Raising Organization**

~~[Paragraphs .186-.187 deleted.]~~

#### ~~**.186**~~

~~*Question*—A member serves as a director or officer of a local United Way or similar organization that operates as a federated fund-raising organization from which local charities receive funds. Some of those charities are clients of the member's firm. Does the member have a conflict of interest under rule 102 [ET section 102.01]?~~

#### ~~**.187**~~

~~*Answer*—Interpretation 102-2 [ET section 102.03] provides that a conflict of interest may occur if a member performs a professional service for a client and the member or his or her firm has a relationship with another entity that could, in the member's professional judgment, be viewed by the client or other appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity and the relationship is disclosed to and consent is obtained from the appropriate parties, performance of the service shall not be prohibited. (If the service being provided is an attest engagement, consult ethics ruling No. 14 [ET section 191.027-.028] under rule 101 [ET section 101.01]).~~

~~[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]~~

~~\* \* \*~~

### **[99.] Member Providing Services for Company Executives**

~~[Paragraphs .198-.199 deleted.]~~

#### ~~**.198**~~

~~*Question*—A member has been approached by a company, for which he or she may or may not perform other professional services, to provide personal financial planning or tax services for its executives. The executives are aware of the company's relationship with the member, if any, and have also consented to the arrangement. The performance of the services could result in the member recommending to the executives actions that may be adverse to the company.~~

What rules of conduct should the member consider before accepting and during the performance of the engagement?

~~.199~~

~~Answer—Before accepting and during the performance of the engagement, the member should consider the applicability of Rule 102, *Integrity and Objectivity* [ET section 102.01]. If the member believes that he or she can perform the personal financial planning or tax services with objectivity, the member would not be prohibited from accepting the engagement. The member should also consider informing the company and the executives of possible results of the engagement. During the performance of the services, the member should consider his or her professional responsibility to the clients (that is, the company and the executives) under Rule 301, *Confidential Client Information* [ET section 301.01].~~

~~\* \* \*~~

**[101.] Client Advocacy and Expert Witness Services**

[Paragraphs .202-.203 deleted.]

~~.202~~

~~Question—Would the performance of expert witness services be considered as acting as an advocate for a client as discussed in interpretation 102-6 [ET section 102.07]?~~

~~.203~~

~~Answer—No. A member serving as an expert witness does not serve as an advocate but as someone with specialized knowledge, training, and experience in a particular area who should arrive at and present positions objectively.~~

~~\* \* \*~~

## APPENDIX 5 – OTHER PROPOSED AMENDMENTS

In connection with the proposal of QC 1000, *A Firm's System of Quality Control* ("QC 1000"), the Board is proposing related amendments to several of its rules, standards, and forms. We are also proposing other technical and clarifying amendments.

QC 1000 would supersede the Board's interim quality control standards in their entirety. Rule 3400T, *Interim Quality Control Standards*, is proposed to be rescinded. In consequence, the interim quality control standards referenced in Rule 3400T, listed below along with the applicable appendices, would no longer be part of PCAOB standards:

- QC Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*;
- QC Section 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*;
- QC Section 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement*;
- SECPS § 1000.08(d), *Continuing Professional Education of Audit Firm Personnel*;
- SECPS § 1000.08(l), *Communication by Written Statement to all Professional Personnel of Firm Policies and Procedures on the Recommendation and Approval of Accounting Principles, Present and Potential Client Relationships, and the Types of Services Provided*;
- SECPS § 1000.08(m), *Notification of the Commission of Resignations and Dismissals from Audit Engagements for Commission Registrants*;
- SECPS § 1000.08(n), *Audit Firm Obligations with Respect to the Policies and Procedures of Correspondent Firms and of Other Members of International Firms or International Associations of Firms*;
- SECPS § 1000.08(o), *Policies and Procedures to Comply with Independence Requirements*;
- SECPS § 1000.38, Appendix D—*Revised Definition of an SEC Client*;
- SECPS § 1000.42, Appendix H—*Illustrative Statement of Firm Philosophy*;
- SECPS § 1000.43, Appendix I—*Standard Form of Letter Confirming the Cessation of the Client-Auditor Relationship*;

- SECPS § 1000.45, Appendix K—*SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants*; and
- SECPS § 1000.46, Appendix L—*Independence Quality Controls*.

Rule 3400T is proposed to be replaced with Rule 3400, which would describe the auditor’s responsibilities for complying with quality control standards adopted by the Board and approved by the SEC.

Language that would be deleted by the proposed amendments is ~~struck through~~.  
Language that would be added is underlined.

## Other PCAOB Rules, Standards, and Forms Proposed to Be Amended<sup>1</sup>

PCAOB Rule, Standard, or Form	Paragraph(s)	Subject Heading of Paragraph(s) Affected	Action	Page
Rule 2204. <i>Signatures</i>	All	All	Amend	p. A5–10
Rule 2205. <i>Amendments</i>	All	All	Amend	p. A5–10
Rule 2206. <i>Date of Filing</i>	(c)	N/A	Add	p. A5–10
Rule 3400T. <i>Interim Quality Control Standards.</i>	All	All	Rescind	p. A5–10
Rule 3400. <i>Quality Control Standards</i>	N/A	N/A	Add	p. A5–11
Rule 3500T. <i>Interim Ethics and Independence Standards</i>	(a)	N/A	Amend	p. A5–11
AS 1005, <i>Independence</i>	.02	N/A	Make conforming amendment	p. A5-11
AS 1010, <i>Training and Proficiency of the Independent Auditor</i>	.01, .02, .03, .04, .05	N/A	Amend	p. A5–12
AS 1110, <i>Relationship of Auditing Standards to Quality Control Standards</i>	All	All	Rescind	p. A5–13

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<sup>1</sup> This table is a reference tool for the proposed amendments that follow. “Add” refers to a new standard, new paragraph, or other text to be added to existing PCAOB rules, standards, or forms. “Amend” refers to substantive changes to existing PCAOB rules, standards, or forms. “Make conforming amendment” refers to technical changes to existing PCAOB standards, such as changes to cross-references and defined terms. “Rescind” refers to removing an existing PCAOB rule or standard.

PCAOB Rule, Standard, or Form	Paragraph(s)	Subject Heading of Paragraph(s) Affected	Action	Page
AS 1215, <i>Audit Documentation</i>	.03	Objectives of Audit Documentation	Make conforming amendment	p. A5-14
AS 1215	.09	Audit Documentation Requirement	Make conforming amendment	p. A5-14
AS 1215	.11	Documentation of Specific Matters	Make conforming amendment	p. A5-15
AS 1220, <i>Engagement Quality Review</i>	.04	Qualifications of an Engagement Quality Reviewer	Amend	p. A5-15
AS 1220	.05	Competence	Amend footnote 3	p. A5-15
AS 1220	.10a	Engagement Quality Review for an Audit  Engagement Quality Review Process	Make conforming amendment	p. A5-16
AS 1220	.15a	Engagement Quality Review for a Review of Interim Financial Information	Make conforming amendment	p. A5-16

PCAOB Rule, Standard, or Form	Paragraph(s)	Subject Heading of Paragraph(s) Affected	Action	Page
		Engagement Quality Review Process		
AS 1301, <i>Communications with Audit Committees</i>	.03a	Objectives	Make conforming amendment	p. A5-16
AS 1301	.04	Appointment and Retention  Significant Issues Discussed with Management in Connection with the Auditor’s Appointment or Retention	Renumber as .04a	p. A5-17
AS 1301	.04b	Appointment and Retention  Significant Issues Discussed with Management in Connection with the Auditor’s Appointment or Retention	Add	p. A5-17
AS 1310, <i>Notification of Termination of the Auditor-Client Relationship</i>	N/A	N/A	Add	p. A5-17

PCAOB Rule, Standard, or Form	Paragraph(s)	Subject Heading of Paragraph(s) Affected	Action	Page
AS 2101, <i>Audit Planning</i>	.06a	Preliminary Engagement Activities	Make conforming amendment to footnote 3	p. A5-18
AS 2101	.07	Planning Activities	Make conforming amendment	p. A5-18
AS 2110, <i>Identifying and Assessing Risks of Material Misstatement</i>	.05c	Performing Risk Assessment Procedures	Make conforming amendment	p. A5-18
AS 2110	.41	Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements	Make conforming amendment	p. A5-19
AS 2201, <i>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</i>	.04	Introduction	Make conforming amendment	p. A5-19
AS 2201	.09	Planning the Audit	Make conforming amendment	p. A5-20

PCAOB Rule, Standard, or Form	Paragraph(s)	Subject Heading of Paragraph(s) Affected	Action	Page
AS 2201	.99	Subsequent Events	Add	p. A5–20
AS 2315, <i>Audit Sampling</i>	.11	Uncertainty and Audit Sampling	Make conforming amendment	p. A5–20
AS 4105, <i>Reviews of Interim Financial Information</i>	.01	Introduction	Make conforming amendment to footnote 1A	p. A5–21
AS 4105	.08	Applicability	Make conforming amendment to footnote 6	p. A5–21
AS 6105, <i>Reports on the Application of Accounting Principles</i>	.07	Performance Standards	Make conforming amendment	p. A5–22
AS 6115, <i>Reporting on Whether a Previously Reported Material Weakness Continues to Exist</i>	.21	Applying the Standards of the PCAOB	Make conforming amendment	p. A5–22
Attestation Standard No. 1, <i>Examination Engagements Regarding Compliance Reports of Brokers and Dealers</i>	6.a	Performing the Examination Engagement  General Requirements	Make conforming amendment	p. A5–22
Attestation Standard No. 1	39., 40., 41., 42.	Responding to Engagement Deficiencies After the	Add	p. A5–23

PCAOB Rule, Standard, or Form	Paragraph(s)	Subject Heading of Paragraph(s) Affected	Action	Page
		Issuance of an Examination Report		
<i>Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers</i>	5.a	Performing the Review Engagement  General Requirements	Make conforming amendment	p. A5–24
Attestation Standard No. 2	21., 22., 23., 24.	Responding to Engagement Deficiencies After the Issuance of a Review Report	Add	p. A5–24
<i>AT Section 101, Attest Engagements</i>	.16, .17, .18	The Relationship of Attestation Standards to Quality Control Standards	Amend	p. A5–25
AT Section 101	.19	General Standards  Training and Proficiency	Make conforming amendment	p. A5–26
AT Section 101	.46	Standards of Fieldwork  Planning and Supervision	Make conforming amendment to footnote 10	p. A5–26

PCAOB Rule, Standard, or Form	Paragraph(s)	Subject Heading of Paragraph(s) Affected	Action	Page
AT Section 101	.103	Attest Documentation	Make conforming amendment to footnote 23	p. A5–26
Form 1 – Application for Registration	1., 3.	General Instructions	Amend	p. A5–27
Form 1	4.2	Part IV - Statement of Applicant’s Quality Control Policies	Add	p. A5–27
Form 2 – Annual Report Form	3.1A	Part III - General Information Concerning the Firm	Add	p. A5–27
Instructions to Form AP – Auditor Reporting of Certain Audit Participants	Part IV	Responsibility for the <i>Audit</i> is Not Divided	Amend	p. A5–28

## Rule 2204. Signatures

Each signatory to a report on Form 2, ~~or Form 3,~~ or Form QC shall manually sign a signature page or other document authenticating, acknowledging or otherwise adopting his or her signature that appears in typed form within the electronic submission. Such document shall be executed before or at the time the electronic submission is made and shall be retained by the filer for a period of seven years. Upon request, an electronic filer shall provide to the Board or its staff a copy of all documents retained pursuant to this Rule.

\* \* \*

## Rule 2205. Amendments

Amendments to a filed report on Form 2, ~~or Form 3,~~ or Form QC shall be made by filing an amended report on the applicable form—2 or Form 3 in accordance with the instructions to ~~these that~~ forms concerning amendments. Amendments shall not be filed to update information in a report that was correct at the time the report was filed, but only to correct information that was incorrect at the time the report was filed or to provide information that was omitted from the report and was required to be provided at the time the report was filed.

\* \* \*

## Rule 2206. Date of Filing

\* \* \*

(a) An annual report shall be deemed to be filed on the date on which the registered public accounting firm submits a Form 2 in accordance with Rule 2200 that includes the signed certification required in Part X of Form 2.

(b) A special report on Form 3 shall be deemed to be filed on the date that the registered public accounting firm submits a Form 3 in accordance with Rule 2203 that includes the signed certification required in Part VIII of Form 3.

(c) A report on the evaluation of the firm’s system of quality control on Form QC shall be deemed to be filed on the date that the registered public accounting firm submits a Form QC in accordance with Rule 2203A that includes the signed certifications required in Parts III and V of Form QC.

\* \* \*

## ~~Rule 3400T. Interim Quality Control Standards.~~

~~A registered public accounting firm, and its associated persons, shall comply with quality control standards, as described in —~~

~~(a) — the AICPA's Auditing Standards Board's Statements on Quality Control Standards, as in existence on April 16, 2003 (AICPA Professional Standards, QC §§ 20–40 (AICPA 2002)), to the extent not superseded or amended by the Board; and~~

~~(b) — the AICPA SEC Practice Section's Requirements of Membership (d), (l), (m), (n)(1) and (o), as in existence on April 16, 2003 (AICPA SEC Practice Section Manual § 1000.08(d), (j), (m), (n)(1) and (o)), to the extent not superseded or amended by the Board.~~

~~Note: The AICPA SEC Practice Section's Requirements of Membership only apply to those registered public accounting firms that were members of the AICPA SEC Practice Section on April 16, 2003.~~

### Rule 3400. Quality Control Standards.

A registered public accounting firm and its associated persons shall comply with all applicable quality control standards adopted by the Board and approved by the SEC.

### Rule 3500T. Interim Ethics and Independence Standards.

\* \* \*

~~(a) In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with ethics standards, as described in ET 1000 and, to the extent not superseded or amended by the Board, the ethics rulings associated with the AICPA's Code of Professional Conduct Rule 102, and interpretations and rulings thereunder, as in existence on April 16, 2003 (AICPA Professional Standards, ET §§ 102 and 191 (AICPA 2002)), to the extent not superseded or amended by the Board.~~

\* \* \*

### AS 1005, Independence

\* \* \*

**.02** The statement in the preceding paragraph requires that the auditor be independent; aside from being in public practice (as distinct from being in private practice), he must be without bias with respect to the client since otherwise he would lack that impartiality necessary for the dependability of his findings, ~~however excellent~~ regardless of his level of competence technical proficiency may be.<sup>1</sup> However, independence does not imply the attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors.

<sup>1</sup> See AS 1010, *Competence of the Independent Auditor* [as proposed to be amended], for a description of competence.

\* \* \*

## AS 1010, ~~Training and Proficiency~~ Competence of the Independent Auditor

### **Objective**

.01 The objective of the auditor is to have the competence to perform their responsibilities in accordance with applicable professional and legal requirements.

### **Competence**

.02 The audit must be performed by an auditor who has the competence to conduct an audit in accordance with applicable professional and legal requirements.<sup>1</sup> Competence consists of having the knowledge, skill, and ability that enable an auditor to perform the assigned activities in accordance with applicable professional and legal requirements and the firm’s policies and procedures. The measure of competence is qualitative rather than quantitative because quantitative measurement may not accurately reflect the experience gained over time.

<sup>1</sup> The term “applicable professional and legal requirements,” as used in this standard, has the same meaning as defined in Appendix A of QC 1000, *A Firm’s System of Quality Control*. See also paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*, for requirements regarding the appropriate assignment of engagement team members, and QC 1000.44a.-e., for relevant quality objectives relating to the firm’s use of resources.

.03 The auditor should develop and maintain competence through an appropriate combination of:

- a. Academic education;
- b. Professional experience in accounting and auditing, with proper supervision;<sup>2</sup> and
- c. Training, including continuing professional education.<sup>3</sup>

<sup>2</sup> Paragraphs .05-.06 of AS 1201, *Supervision of the Audit Engagement*, describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.

<sup>3</sup> See also QC 1000.36 and .48 for the requirements for the firm to provide mandatory training. In addition to mandatory training provided by the firm, independent auditors may need to undertake additional training to develop and maintain their competence.

~~.01— The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.~~

~~.02— The statement in the preceding paragraph recognizes that however capable a person may be in other fields, including business and finance, he cannot meet the requirements of the auditing standards without proper education and experience in the field of auditing.~~

~~.03— In the performance of the audit which leads to an opinion, the independent auditor holds himself out as one who is proficient in accounting and auditing. The attainment of that proficiency begins with the auditor's formal education and extends into his subsequent experience. The independent auditor must undergo training adequate to meet the requirements of a professional. This training must be adequate in technical scope and should include a commensurate measure of general education. The junior assistant, just entering upon an auditing career, must obtain his professional experience with the proper supervision and review of his work by a more experienced superior. The nature and extent of supervision and review must necessarily reflect wide variances in practice. The engagement partner must exercise seasoned judgment in the varying degrees of his supervision and review of the work done and judgments exercised by his subordinates, who in turn must meet the responsibilities attaching to the varying gradations and functions of their work.~~

~~.04— The independent auditor's formal education and professional experience complement one another; each auditor exercising authority upon an engagement should weigh these attributes in determining the extent of his supervision of subordinates and review of their work. It should be recognized that the training of a professional man includes a continual awareness of developments taking place in business and in his profession. He must study, understand, and apply new pronouncements on accounting principles and auditing procedures as they are developed by authoritative bodies within the accounting profession.~~

~~.05— In the course of his day-to-day practice, the independent auditor encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement. He is retained to audit and report upon the financial statements of a business because, through his training and experience, he has become skilled in accounting and auditing and has acquired the ability to consider objectively and to exercise independent judgment with respect to the information recorded in books of account or otherwise disclosed by his audit.~~

## ~~AS 1110, Relationship of Auditing Standards to Quality Control Standards~~

~~.01— The independent auditor is responsible for compliance with the standards of the PCAOB in an audit engagement.~~

~~.02— A firm of independent auditors has a responsibility to adopt a system of quality control in conducting an audit practice.<sup>2</sup> Thus, a firm should establish quality control policies and~~

~~procedures to provide it with reasonable assurance that its personnel comply with the standards of the PCAOB in its audit engagements. The nature and extent of a firm's quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations.~~

~~.03— Auditing standards relate to the conduct of individual audit engagements; quality control standards relate to the conduct of a firm's audit practice as a whole. Thus, auditing standards and quality control standards are related, and the quality control policies and procedures that a firm adopts may affect both the conduct of individual audit engagements and the conduct of a firm's audit practice as a whole. However, deficiencies in or instances of noncompliance with a firm's quality control policies and procedures do not, in and of themselves, indicate that a particular audit engagement was not performed in accordance with the auditing standards.~~

~~<sup>2</sup>— The elements of quality control are identified in Statement on Quality Control Standards (SQCS) No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice [QC section 20]. A system of quality control is broadly 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.~~

## AS 1215, Audit Documentation

.03 Audit documentation is reviewed by members of the engagement team performing the work and might be reviewed by others. Reviewers might include, for example:

\* \* \*

e. Internal and external inspection teams that review documentation to assess audit quality and compliance with applicable professional and legal requirements~~auditing and related professional practice standards; applicable laws, rules, and regulations; and the auditor's own quality control policies and procedures.~~

<sup>1</sup> "Applicable professional and legal requirements" is defined in paragraph .A2 of QC 1000, A Firm's System of Quality Control.

\* \* \*

.09 If, after the documentation completion date (defined in paragraph .15), the auditor becomes aware, as a result of a lack of documentation or otherwise, that audit procedures may not have been performed, evidence may not have been obtained, or appropriate conclusions may not have been reached, the auditor must determine, and if so demonstrate, that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions

were reached with respect to the relevant financial statement assertions. To accomplish this, the auditor must have persuasive other evidence. Oral explanation alone does not constitute persuasive other evidence, but it may be used to clarify other written evidence.

\* \* \*

- If the auditor cannot determine or demonstrate that sufficient procedures were performed, sufficient evidence was obtained, or appropriate conclusions were reached, the auditor should comply with the provisions of AS 2901, Responding to Engagement Deficiencies After Issuance of the Auditor’s Report [as proposed to be amended]~~Consideration of Omitted Procedures After the Report Date.~~

\* \* \*

**.11** Certain matters, such as auditor independence, staff competence, training ~~and proficiency~~ and client acceptance and continuance ~~retention~~, may be documented in a central repository for the public accounting firm (“firm”) or in the particular office participating in the engagement. If such matters are documented in a central repository, the audit documentation of the engagement should include a reference to the central repository. Documentation of matters specific to a particular engagement should be included in the audit documentation of the pertinent engagement.

\* \* \*

## AS 1220, Engagement Quality Review

\* \* \*

**.04** As described below, an engagement quality reviewer must have competence, independence, integrity, and objectivity.

Note: QC 1000, A Firm’s System of Quality Control, includes provisions addressing the engagement quality reviewer’s competence, independence, integrity, and objectivity. See QC 1000.33b.-c. and e., and .44a. and d. ~~The firm’s quality control policies and procedures should include provisions to provide the firm with reasonable assurance that the engagement quality reviewer has sufficient competence, independence, integrity, and objectivity to perform the engagement quality review in accordance with the standards of the PCAOB.~~

### Competence

**.05** The engagement quality reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.<sup>3</sup>

<sup>3</sup> See also QC 1000.45c. and .48 on competence to perform engagements and fulfill assigned roles. The term “engagement partner” has the same meaning as the “practitioner in charge of an engagement” in PCAOB interim quality control standard QC sec. 40, *The Personnel Management Element of a Firm’s System of Quality Control—Competencies Required by a Practitioner in Charge of an Attest Engagement*. QC sec. 40 describes the competencies required of a practitioner in charge of an attest engagement.

\* \* \*

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

- a. Evaluate the significant judgments that relate to engagement planning, including –
  - The consideration of the firm’s recent engagement experience with the company and risks identified in connection with the firm’s client acceptance and continuance retention process evaluation,

\* \* \*

**.15** In a review of interim financial information, the engagement quality reviewer should:

- a. Evaluate the significant judgments that relate to engagement planning, including the consideration of –
  - The firm’s recent engagement experience with the company and risks identified in connection with the firm’s client acceptance and continuance retention process evaluation,

\*\*\*

## AS 1301, Communications with Audit Committees

\* \* \*

**.03** The objectives of the auditor are to:

- a. Communicate to the audit committee the responsibilities certain issues in connection with the auditor’s appointment or retention of the auditor in relation to the audit and establish an understanding of the terms of the audit engagement with the audit committee;

\* \* \*

## **Significant Issues Discussed with Management in Connection with the Auditor's Appointment or Retention**

- .04** The auditor should discuss with the audit committee:
- a. Any significant issues that the auditor discussed with management in connection with the appointment or retention of the auditor, including significant discussions regarding the application of accounting principles and auditing standards; and
  - b. The conclusion of the firm's most recent annual evaluation of its QC system under paragraph .77 of QC 1000, *A Firm's System of Quality Control*, and a brief overview of remedial actions taken and to be taken.

\* \* \*

## [AS 1310, Notification of Termination of the Auditor-Client Relationship](#)

### **Objective**

**.01** The objective of the auditor is to ensure that the issuer and the SEC are notified when an auditor-client relationship has ended.

### **Circumstances Requiring Notification**

- .02** If
- a. the principal auditor who was previously engaged to audit the financial statements of an issuer, or an other auditor whose report is being referenced in the principal auditor's report on the financial statements of an issuer, resigns (or declines to stand for re-appointment after completion of the current audit) or is dismissed; and
  - b. the issuer does not report an auditor change by filing a timely current report on Form 8-K;

the auditor should notify the issuer and the SEC in writing that the auditor-client relationship has ended.

### **Timing of Notification**

**.03** The auditor should send the notice to the issuer and the SEC by the end of the fifth business day following the auditor's determination that the auditor-client relationship has ended.

### **Form of Notification to the SEC**

**.04** The notice to the SEC should be submitted in the form and with the content described on the webpage of the SEC’s Office of the Chief Accountant, or as the SEC may otherwise direct.

\* \* \*

## AS 2101, Audit Planning

\* \* \*

### Preliminary Engagement Activities

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

- a. Perform procedures regarding the continuance of the client relationship and the specific audit engagement,<sup>3</sup>

<sup>3</sup> ~~See Paragraphs .38 of QC 1000, A Firm’s System of Quality Control.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.~~

\* \* \*

**.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 about risks related to the company evaluated as part of the auditor’s client acceptance and continuance ~~retention~~ evaluation; and

\* \* \*

## AS 2110, Identifying and Assessing Risks of Material Misstatement

\* \* \*

**.05** Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company’s industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial

reporting. For example, external or company-specific factors can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets. Also, risks of material misstatement may relate to, e.g., personnel who lack the necessary financial reporting competencies, information systems that fail to accurately capture business transactions, or financial reporting processes that are not adequately aligned with the requirements in the applicable financial reporting framework. Thus, the audit procedures that are necessary to identify and appropriately assess the risks of material misstatement include consideration of both external factors and company-specific factors. This standard discusses the following risk assessment procedures:

\* \* \*

- c. Considering information from the client acceptance and continuance retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs .41-.45);

\* \* \*

#### **Considering Information from the Client Acceptance and Continuance Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements**

**.41** *Client Acceptance and Continuance Retention and Audit Planning Activities.* The auditor should evaluate whether information obtained from the client acceptance and continuance retention evaluation process or audit planning activities is relevant to identifying risks of material misstatement. Risks of material misstatement identified during those activities should be assessed as discussed beginning in paragraph .59 of this standard.

\* \* \*

### **AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements**

\* \* \*

**.04** ~~The standards, AS 1005, *Independence*, AS 1010, *Competence Training and Proficiency of the Independent Auditor* [as proposed to be amended], and AS 1015, *Due Professional Care in the Performance of Work*, are applicable to an audit of internal control over financial reporting. Those standards require an auditor to have competence technical training and proficiency as an auditor, be independent, and the exercise of due professional care, including professional skepticism, when conducting an audit. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.~~

\* \* \*

**.09** The auditor should properly plan the audit of internal control over financial reporting and properly supervise the engagement team members. When planning an integrated audit, 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 about risks related to the company evaluated as part of the auditor’s client acceptance and continuance ~~retention~~ evaluation; and

\* \* \*

.99 After the issuance of the report on internal control over financial reporting, the auditor may identify information that indicates the existence of an engagement deficiency.<sup>20</sup> When the auditor has determined that an engagement deficiency exists, the auditor should take action to address the deficiency in accordance with AS 2901, *Responding to Engagement Deficiencies After Issuance of the Auditor’s Report* [as proposed to be amended], unless it is probable that the audit report is not being relied upon.

Note: The auditor must treat as relied upon any report on internal control over financial reporting that is included in an issuer’s most recent filing on an SEC form that requires inclusion of such an audit report.

<sup>20</sup> “Engagement deficiency” is defined in QC 1000, *A Firm’s System of Quality Control*, Appendix A—*Definitions*. See paragraph .67 of QC 1000 on determining when an engagement deficiency exists.

\* \* \*

## AS 2315, Audit Sampling

\* \* \*

**.11** Nonsampling risk includes all the aspects of audit risk that are not due to sampling. An auditor may apply a procedure to all transactions or balances and still fail to detect a material misstatement. Nonsampling risk includes the possibility of selecting audit procedures that are not appropriate to achieve the specific objective. For example, confirming recorded receivables cannot be relied on to reveal unrecorded receivables. Nonsampling risk also arises because the auditor may fail to recognize misstatements included in documents that he examines, which would make that procedure ineffective even if he were to examine all items. Nonsampling risk can be reduced to a negligible level through such factors as adequate planning and supervision

and proper conduct of a firm’s audit practice (~~see AS 1110, *Relationship of Auditing Standards to the Quality Control Standards*~~).

\* \* \*

## AS 4105, Reviews of Interim Financial Information

### Introduction

**.01** The purpose of this section is to establish standards and provide guidance on the nature, timing, and extent of the procedures to be performed by an independent accountant when conducting a review of *interim financial information* (as that term is defined in paragraph .02 of this section). The general standards<sup>1A</sup> are applicable to a review of interim financial information conducted in accordance with this section. This section provides guidance on the application of the field work and reporting standards to a review of interim financial information, to the extent those standards are relevant.

<sup>1A</sup> See AS 1005, *Independence*, AS 1010, *Competence Training and Proficiency of the Independent Auditor* [as proposed to be amended], and AS 1015, *Due Professional Care in the Performance of Work*.

\* \* \*

### Establishing an Understanding with the Audit Committee

**.08** The accountant should establish an understanding of the terms of an engagement to review interim financial information with the audit committee or others with equivalent authority and responsibility (hereafter referred to as the audit committee).<sup>6</sup> This understanding includes the objective of the review of interim financial information, the responsibilities of the accountant, and the responsibilities of management. Such an understanding reduces the risk that either the accountant or the audit committee may misinterpret the needs or expectations of the other party. The accountant should record this understanding of the terms of the engagement in an engagement letter and should provide the engagement letter to the audit committee. The accountant should have the engagement letter executed by the appropriate party or parties on behalf of the company. If the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the accountant should determine that the audit committee has acknowledged and agreed to the terms of the engagement. If the accountant believes he or she cannot establish an understanding of the terms of an engagement to review interim financial information with the audit committee, the accountant should decline to accept, continue, or perform the engagement.

<sup>6</sup> See paragraph ~~.38b.16~~ of QC 1000, *A Firm’s System of Quality Control*~~sec. 20, *System of Quality Control for a CPU Firm’s Accounting and Auditing Practice*~~.

\* \* \*

## AS 6105, Reports on the Application of Accounting Principles

\* \* \*

**.07** The reporting accountant should exercise due professional care in performing the engagement and should have the competence to conduct such an engagement ~~adequate technical training and proficiency~~. The reporting accountant should also plan the engagement adequately, supervise the work of assistants, if any, and accumulate sufficient information to provide a reasonable basis for the professional judgment described in the report. The reporting accountant should consider the circumstances under which the written report or oral advice is requested, the purpose of the request, and the intended use of the written report or oral advice.

\* \* \*

## AS 6115, Reporting on Whether a Previously Reported Material Weakness Continues to Exist

\* \* \*

**.21** The engagement to report on whether a previously reported material weakness continues to exist must be performed by a person or persons having the competence ~~adequate technical training and proficiency as an auditor~~ to conduct such an engagement. In all matters related to the assignment, an independence in mental attitude must be maintained. Due professional care must be exercised in the performance of the engagement and the preparation of the report.

\* \* \*

## Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers

\* \* \*

- 6.** An auditor who performs an examination engagement pursuant to this standard must:
  - a. Have ~~adequate technical proficiency~~ competence in attestation engagements;<sup>10A</sup>

\* \* \*

<sup>10A</sup> See paragraph .44 of QC 1000, *A Firm's System of Quality Control*, for a description of competence.

\* \* \*

### **Responding to Engagement Deficiencies After the Issuance of an Examination Report**

**39.** After the issuance of the examination report, the auditor may identify information that indicates the existence of an engagement deficiency.<sup>20</sup> When the auditor has determined that an engagement deficiency exists, the auditor should take action to address the deficiency unless it is probable<sup>21</sup> that the examination report is not being relied upon.

Note: The auditor must treat as relied upon any examination report that is included in a broker’s or dealer’s most recent filing on an SEC form that requires inclusion of such an examination report.

**40.** For engagement deficiencies where the auditor did not obtain appropriate evidence that is sufficient to support the auditor’s opinion, the auditor should:

- a. Perform procedures to obtain additional evidence, to the extent necessary, such that the opinion is supported by appropriate evidence that is sufficient; or
- b. Take action to prevent future reliance on the report.

**41.** For other engagement deficiencies, the auditor should take action to address the deficiency, taking into account the nature and severity of the deficiency.

Note: Remedial actions a firm may take include: (1) corrective actions to address engagement deficiencies on completed engagements; and (2) preventive actions to deter future engagement deficiencies.

**42.** The auditor should comply with:

- a. Paragraph .16 of AS 1215, *Audit Documentation*, when documenting its response to engagement deficiencies within the working papers; and
- b. QC 1000.82c when documenting the actions taken to address engagement deficiencies as part of the monitoring and remediation process of its QC system.

<sup>20</sup> “Engagement deficiency” is defined in QC 1000, *A Firm’s System of Quality Control*, Appendix A—*Definitions*. See paragraph .67 of QC 1000 on determining when an engagement deficiency exists.

<sup>21</sup> The term “probable” has the same meaning as used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

## Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers

\* \* \*

5. An auditor who performs a review engagement must:
- a. Have ~~adequate technical proficiency~~ competence in attestation engagements;<sup>7A</sup>

\* \* \*

<sup>7A</sup> See paragraph .44 of QC 1000, *A Firm's System of Quality Control*, for a description of competence.

\* \* \*

### **Responding to Engagement Deficiencies After the Issuance of a Review Report**

**21.** After the issuance of the review report, the auditor may identify information that indicates the existence of an engagement deficiency.<sup>14</sup> When the auditor has determined that an engagement deficiency exists, the auditor should take action to address the deficiency unless it is probable<sup>15</sup> that the review report is not being relied upon.

Note: The auditor must treat as relied upon any review report that is included in a broker's or dealer's most recent filing on an SEC form that requires inclusion of such a review report.

**22.** For engagement deficiencies where the auditor did not obtain appropriate evidence that is sufficient to obtain moderate assurance, the auditor should:

- a. Perform procedures to obtain additional evidence, to the extent necessary, such that the opinion is supported by appropriate evidence that is sufficient to obtain moderate assurance; or
- b. Take action to prevent future reliance on the report.

**23.** For other engagement deficiencies, the auditor should take action to address the deficiency, taking into account the nature and severity of the deficiency.

Note: Remedial actions a firm may take include: (1) corrective actions to address engagement deficiencies on completed engagements; and (2) preventive actions to deter future engagement deficiencies.

**24.** The auditor should comply with:

- a. Paragraph .16 of AS 1215, *Audit Documentation*, when documenting its response to engagement deficiencies within the working papers; and
- b. QC 1000.82c when documenting the actions taken to address engagement deficiencies as part of the monitoring and remediation process of its QC system.

<sup>14</sup> “Engagement deficiency” is defined in QC 1000, *A Firm’s System of Quality Control*, Appendix A—*Definitions*. See paragraph .67 of QC 1000 on determining when an engagement deficiency exists.

<sup>15</sup> The term “probable” has the same meaning as used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

## AT Section 101, Attest Engagements

\* \* \*

### The Relationship of Attestation Standards to Quality Control Standards

~~.16— The practitioner is responsible for compliance with the American Institute of Certified Public Accountants’ (AICPA’s) Statements on Standards for Attestation Engagements (SSAEs) in an attest engagement. Rule 202, *Compliance With Standards*, of the Code of Professional Conduct [ET section 202.01], requires members to comply with such standards when conducting professional services.~~

[.16] [Paragraph deleted.]

~~.17— A firm of practitioners has a responsibility to in the conduct of a firm’s attest practice.<sup>fn 6</sup> Thus, a firm should establish quality control policies and procedures to provide it with reasonable assurance that its personnel comply with the attestation standards in its attest engagements. The nature and extent of a firm’s quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations.~~

~~<sup>fn 6</sup>— The elements of quality control are identified in Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice* [QC section 20]. A system of quality control is broadly 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.~~

[.17] [Paragraph deleted.]

~~.18— Attestation standards relate to the conduct of individual attest engagements; quality control standards relate to the conduct of a firm's attest practice as a whole. Thus, attestation standards and quality control standards are related and the quality control policies and procedures that a firm adopts may affect both the conduct of individual attest engagements and the conduct of a firm's attest practice as a whole. However, deficiencies in or instances of noncompliance with a firm's quality control policies and procedures do not, in and of themselves, indicate that a particular engagement was not performed in accordance with attestation standards.~~

[.18] [Paragraph deleted.]

### **Training and Proficiency Competence**

~~.19 The first general standard is—The engagement shall be performed by a practitioner having adequate technical training and proficiency competence in the attest function.<sup>fn 6</sup>~~

~~<sup>fn 6</sup> See paragraph .44 of QC 1000, *A Firm's System of Quality Control*, for a description of competence.~~

\* \* \*

~~.46 The practitioner should establish an understanding with the client regarding the services to be performed for each engagement.<sup>fn 10</sup> Such an understanding reduces the risk that either the practitioner or the client may misinterpret the needs or expectations of the other party. For example, it reduces the risk that the client may inappropriately rely on the practitioner to protect the entity against certain risks or to perform certain functions that are the client's responsibility. The understanding should include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, and limitations of the engagement. The practitioner should document the understanding in the working papers, preferably through a written communication with the client. If the practitioner believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement.~~

~~<sup>fn 10</sup> See QC 1000.38b SQCS No. 2, paragraph 16 [QC section 20.16].~~

\* \* \*

~~.103 Attest documentation should be sufficient to (a) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of attest procedures performed, and the information obtained<sup>fn 23</sup> and (b) indicate the engagement team member(s) who performed and reviewed the work.~~

~~<sup>fn 23</sup>— A firm of practitioners has a responsibility to adopt a system of quality control policies and procedures to provide the firm with reasonable assurance that its personnel comply with~~

~~applicable professional standards, including attestation standards, and the firm's standards of quality in conducting individual attest engagements. Review of attest documentation and discussions with engagement team members are among the procedures a firm performs when monitoring compliance with the quality control policies and procedures that it has established. (Also, see paragraphs .17 and .18.)~~

[fn 23] [Footnote deleted.]

\* \* \*

## Form 1 - Application for Registration

1. The definitions in the *Board's* rules and in QC 1000, A Firm's System of Quality Control, apply to this form. Italicized terms in the instructions to this form are defined in the *Board's* rules or QC 1000, as the case may be. See Rule 1001.

\* \* \*

3. In addition to these instructions, the *rules* contained in Section 2 of the *Board's rules* govern applications for registration, and QC 1000 addresses the responsibility of a *registered public accounting firm* to design and, when applicable, implement and operate an effective QC system for its *engagements*. Please read these *rules*, QC 1000, and the instructions carefully before completing this form.

\* \* \*

### Item 4.2 Design of the Firm's System of Quality Control

Indicate, by checking the applicable box, whether the *public accounting firm* has designed a QC system in accordance with QC 1000:

     Yes.

     No.

\* \* \*

## Form 2 - Annual Report Form

\* \* \*

### Item 3.1A The Firm's System of Quality Control

a.      Indicate, by checking the applicable box, whether the firm has designed a QC system in accordance with QC 1000:

Yes.

       No.

b. Indicate, by checking the applicable box, whether the firm was required, at any time during the reporting period, to implement and operate an effective QC system in accordance with QC 1000:

       Yes.

       No.

\* \* \*

## Form AP – Auditor Reporting of Certain Audit Participants

### **PART IV - RESPONSIBILITY FOR THE *AUDIT* IS NOT DIVIDED**

In responding to Part IV, total *audit* hours in the most recent period's *audit* should be comprised of hours attributable to: (1) the financial statement *audit*; (2) reviews pursuant to AS 4105, *Reviews of Interim Financial Information*; and (3) the *audit* of internal control over financial reporting pursuant to AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Excluded from disclosure and from total *audit* hours in the most recent period's *audit* are, respectively, the identity and hours incurred by: (1) the engagement quality reviewer; ~~(2) the person who performed the review pursuant to SEC Practice Section 1000.45 Appendix K;~~ (3) specialists engaged, not employed, by the Firm; (4) an accounting firms in performing the audit of entities in which the issuer has an investment that is accounted for using the equity method; (5) internal auditors, other company personnel, or third parties working under the direction of management or the audit committee who provided direct assistance in the *audit* of internal control over financial reporting; and (6) internal auditors who provided direct assistance in the *audit* of the financial statements. Hours incurred in the *audit* by entities other than *other accounting firms* are included in the calculation of total *audit* hours and should be allocated among the Firm and the *other accounting firms* participating in the *audit* on the basis of which accounting firm commissioned and directed the applicable work.