



A FIRM'S SYSTEM OF QUALITY CONTROL

AND OTHER AMENDMENTS TO PCAOB STANDARDS, RULES, AND FORMS

PCAOB Release No. 2024-005

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PCAOB Rulemaking

Docket Matter No. 046

Summary: The Public Company Accounting Oversight Board (“PCAOB” or the “Board”) is adopting a new quality control standard, together with other amendments to PCAOB standards, rules, and forms. These 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 monitor for and 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 our attestation standards for broker-dealer engagements;
- (4) supersede our existing standard ET 102, *Integrity and Objectivity*, 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.

Board

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I. EXECUTIVE SUMMARY

We are adopting a new PCAOB quality control (“QC”) standard that we believe will lead registered public accounting firms (“firms”) to significantly improve their QC systems. An effective QC system protects investors by facilitating the consistent preparation and issuance of informative, accurate, independent, and compliant engagement reports. Properly conducted audits and other engagements enhance the confidence of investors and other market participants in the information firms report on.

We are adopting an integrated, risk-based standard, QC 1000, *A Firm’s System of Quality Control*, that mandates quality objectives and key processes for all firms’ QC systems, with a focus on accountability and continuous improvement. We have designed QC 1000 to be applied by firms of varying size and complexity. If approved by the U.S. Securities and Exchange Commission (“SEC”), we believe this new standard will lead firms to better serve investors by more consistently complying with the professional and legal requirements that apply to PCAOB engagements.

In connection with the adoption of QC 1000, we are also adopting other changes to our standards, rules, and forms. QC 1000 and the other changes adopted today substantially reflect our November 2022 proposal,¹ but have been modified in response to commenter input.

In a separate release, the Board is adopting a new auditing standard, AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*, that addresses the general principles and responsibilities of the auditor.² This release includes references to AS 1000, where appropriate.

Improving Our QC Standards

The Board strongly believes that an effective quality control system facilitates continuous improvement. Over time, our oversight experience suggests that firm QC systems fall short. For example, PCAOB inspectors observed that approximately 40% of the issuer audits they reviewed in 2022 had one or more deficiencies where the auditor failed to obtain sufficient appropriate audit evidence to support its opinion, an increase of six percentage points over the deficiency rate in 2021 and 11 percentage points over the rate in 2020.³ In all

¹ See *A Firm’s System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms*, PCAOB Rel. No. 2022-006 (Nov. 18, 2022) (“proposal” or “proposed standards”), available on the Board’s website in Docket 046.

² See *General Responsibilities of the Auditor in Conducting an Audit and Amendments to PCAOB Standards*, PCAOB Release No. 2024-004 (May 13, 2024) (“Auditor Responsibilities Release”).

³ See *Spotlight: Staff Update and Preview of 2022 Inspection Observations* (July 2023) (“2022 Inspection Observations Preview”), at 3, available at <https://assets.pcaobus.org/pcaob->

those cases, auditors issued audit opinions without completing the audit work that PCAOB standards require for them to obtain reasonable assurance about whether the financial statements were free of material misstatement and/or whether the issuers maintained, in all material respects, effective internal control over financial reporting.

Every step of this rulemaking—from the December 2019 concept release,⁴ to the proposal, to the actions we take today—has been informed by extensive research and outreach, as well as by our inspections and enforcement activities. Our current QC standards were developed decades ago and issued by the American Institute of Certified Public Accountants (“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, such as other accounting firms and providers of support services. Firms themselves have also changed significantly, as has the role of firm networks. 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. These developments have, in part, led to our advisory groups’ general support for strengthening the QC standards, including through risk-based elements and enhanced requirements for firm governance and leadership.

Taking into account those considerations, as well as the comments we have received on our concept release and proposal, we believe that improving our standards will lead firms to improve their QC systems. This should result in more consistent compliance with applicable requirements, which ultimately better serves and protects investors. The specific improvements we are adopting today include:

- Emphasizing accountability, firm culture and the “tone at the top,” and firm governance through requirements for specified roles within and responsibilities for the QC system, including at the highest levels of the firm; quality objectives that link compensation to quality; and, for the largest firms, the requirement of an independent perspective in firm governance;
- Striking the right balance between a risk-based approach to QC—which should drive firms to proactively identify and manage the specific risks associated with their practice—and a set of mandates, including required risk assessment and other QC-related processes, quality objectives, and quality responses—which should assure that

[dev/docs/default-source/documents/spotlight-staff-preview-2022-inspection-observations.pdf?sfvrsn=1b116d49_4](https://www.pcaob.org/dev/docs/default-source/documents/spotlight-staff-preview-2022-inspection-observations.pdf?sfvrsn=1b116d49_4).

⁴ See *Concept Release, Potential Approach to Revisions to PCAOB Quality Control Standards*, PCAOB Rel. No. 2019-003 (Dec. 17, 2019) (“concept release”), available on the Board’s website in Docket 046.

the QC system is designed, implemented, and operated with an appropriate level of rigor;

- 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;
- Broadening responsibilities for monitoring and remediation of deficiencies to create a more effective ongoing feedback loop that drives continuous improvement; and
- Requiring a rigorous annual evaluation of the firm’s QC system and related reporting to the PCAOB, certified by key firm personnel, to underscore the importance of the annual evaluation of the QC system, reinforce individual accountability, and support PCAOB oversight.

Framework of the QC Standard

We carefully considered the characteristics of an appropriate framework for a PCAOB QC standard that could accomplish our regulatory goals. As a threshold issue, Section 103 of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) provides that our QC standards must include requirements regarding certain specified matters, and also grants us broad authority to include such other requirements as we may prescribe in carrying out our investor protection mandate. We also considered how best to capture areas we had identified for improvement and how best to foster consistent, compliant implementation by the firms we regulate. Because we believe it is the best structure for accomplishing our goals, we are adopting the QC 1000 framework as proposed.

We note that the framework has commonalities with other international and domestic standards for firm QC systems, though it goes beyond those requirements in a number of areas, including with regard to firm governance of the largest firms, more specific requirements for monitoring and remediation and the evaluation of the QC system, an ethics and independence component aligned with SEC and PCAOB requirements, and more specific provisions addressing technology and externally communicated firm-level and engagement-level information and metrics. We believe that building on a well-understood basic framework, appropriately tailored and strengthened to address our legal and regulatory environment and our investor protection mandate, will enable firms to implement and comply with QC 1000 more effectively. In designing, implementing, and operating their QC systems, firms that are subject to both PCAOB standards and other international or domestic QC standards—which we believe constitute a very substantial majority of the firms that perform engagements under our standards—can leverage the work they have already done and the investments they have already made to comply with those other requirements.

QC 1000

We have developed QC 1000 with a view to our statutory mandate to protect the interests of investors and the public interest, and we believe the new standard will facilitate the consistent preparation and issuance of informative, accurate, and independent engagement reports. The final standard provides a framework for a QC system that is grounded in an ongoing process of 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, firm culture, and individual accountability, and specific direction in a number of areas that our current standards do not address directly.

QC 1000 primarily consists 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 engagements
- Engagement performance
- Resources
- Information and communication

Requirements for evaluation of and reporting on the QC system

- Annual evaluation of the effectiveness of the QC system
- Reporting to the PCAOB on the QC system evaluation

The standard also includes requirements regarding individual roles and responsibilities in the QC system and documentation requirements. The text of QC 1000 is attached as Appendix 1 and the QC reporting rule and new Form QC are attached as Appendix 2.

Scalability

In our view, the basic objectives of the QC system should be the same for all firms, but the scope of the QC standard and how it applies should take into account the wide disparities in nature and circumstances across registered firms, in particular the extent to which their practices include engagements required to be performed under PCAOB standards and the complexity of such engagements. The risks that firms face, and therefore the specific policies and procedures necessary to appropriately serve investor interests through an effective QC system, vary significantly from the largest firms, operating as part of global networks, to local firms or sole proprietorships.

QC 1000 establishes a uniform basic structure to be used by all firms, within which firms will be required to pursue an approach to quality control that is appropriate in light of the risks associated with their particular PCAOB audit practice. Aspects of the new standard are risk-based, and to that extent inherently scalable. In addition, it imposes more stringent requirements for the largest firms in some areas, while enabling smaller firms to comply with the core requirements in ways that take into account these firms' size and the complexity of audits performed by them.

Scalability: Larger PCAOB Audit Practice. We believe that firms with a particularly extensive PCAOB audit practice (i.e., those that issue audit reports for more than 100 issuers per year) 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. The incremental requirements under QC 1000 for such firms include:

- An external oversight function for the QC system composed of one or more persons who can exercise independent judgment related to the QC system;
- A program for collecting and addressing complaints and allegations that includes confidentiality protections;
- An automated system to track investments that may bear on independence; and
- Required monitoring of in-process engagements.

Scalability: Smaller PCAOB Audit Practice. Many firms perform only a small number of PCAOB engagements per year and are subject to resource constraints that larger PCAOB audit practices do not face. We have addressed the particular needs of these firms in a number of ways, including:

- Providing that a single individual may be assigned more than one of the QC system oversight roles required under the standard; and

- Allowing firms that issue five or fewer engagement reports for issuers or broker-dealers in a year to include audits not performed under PCAOB auditing standards in some of their monitoring activities.

Scalability: Firms that do not have responsibilities in relation to a PCAOB engagement.

All registered firms will be required to design a QC system that meets the requirements of QC 1000. Firms will be required to implement and operate the QC system in compliance with QC 1000 when they lead 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. This approach reflects our view that all firms that register with the PCAOB should be appropriately prepared to perform a PCAOB engagement, regardless of whether they are currently subject to requirements with respect to one, while limiting the costs of compliance in circumstances where the risk to investor protection is minimal.

Key Changes from the QC 1000 Proposal

Key changes from the proposal include:

- For the firms with larger PCAOB audit practices, the requirement to include an independent oversight function for their QC system has been refined. Under the final rule, the external quality control function (“EQCF”) will be composed of one or more persons who are not principals or employees of the firm and do not otherwise have a relationship with the firm that would interfere with the exercise of independent judgment with regard to matters related to the QC system. The responsibilities of the EQCF may vary across firms but include, at a minimum, evaluating the significant judgments made and the related conclusions reached by the firm when evaluating and reporting on the effectiveness of its QC system.
- The final rule requires firms to report on their QC system evaluation to the PCAOB, but not to the audit committee, as proposed. Legal constraints limit our ability to require public disclosures about the effectiveness of firms’ QC systems at the level that some investors have requested. While the final rule recognizes the impediments to requiring public disclosure of QC system evaluation, the Board remains committed to finding additional ways of providing public disclosure to better inform investors about firms and PCAOB audit engagements. To that end, we have separately proposed a set of firm-level and engagement-level metrics across 11 areas that would be reported publicly.⁵
- The timing of the QC system evaluation and reporting has changed. Under the final rule, the evaluation date for the annual evaluation of the QC system is September 30, rather

⁵ See *Firm and Engagement Metrics*, PCAOB Rel. No. 2024-002, (Apr. 9, 2024).

than November 30 as proposed, with Form QC due by November 30 rather than January 15 of the following year. This shift allows more time between the evaluation date and the filing date than we proposed, but still allows sufficient time to generally enable the firm's monitoring activities to identify deficiencies in calendar year-end engagements and the results of that monitoring to be included in the evaluation.

Other Changes to PCAOB Standards, Rules, and Forms

In connection with the adoption of QC 1000, we are also adopting 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, *Integrity and Objectivity*, 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 amendments to AS 2901, the amendments related to EI 1000, and the other changes adopted today are attached as Appendices 3, 4, and 5, respectively.

Effective Date

If approved by the SEC, the final standard and related amendments to auditing standards, rules, and forms will take effect on December 15, 2025, with the initial evaluation of the QC system to be performed as of September 30, 2026, and initial reporting to the PCAOB by November 30, 2026. Firms will 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 and related amendments.

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, our December 2019 concept release and 2022 proposal, 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

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.⁶ 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.⁷

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 firm's standards of quality.⁸ The QC system encompasses the firm's organizational structure and the policies adopted and procedures established to provide that reasonable assurance.⁹

⁶ 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."

⁷ See Section 103(a)(2)(B) of Sarbanes-Oxley, 15 U.S.C. § 7213(a)(2)(B).

⁸ See paragraph .03 of QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

⁹ See QC 20.04.

Current PCAOB QC standards were adopted on an interim, transitional basis in 2003 from QC standards originally developed and issued by the AICPA.¹⁰ They include three general QC standards that apply to all firms.¹¹ 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.¹² In the context of engagement performance, the system of quality control should also provide reasonable assurance that the work performed meets applicable regulatory requirements.¹³

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
- Monitoring.¹⁴

¹⁰ See PCAOB Rule 3400T, *Interim Quality Control Standards*; see also *Establishment of Interim Professional Auditing Standards*, PCAOB Rel. No. 2003-006 (Apr. 18, 2003).

¹¹ 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."

¹² See QC 20.03.

¹³ See QC 20.17.

¹⁴ See QC 20.07.

These elements of quality control are interrelated.¹⁵ 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.¹⁶ These policies and procedures should be communicated in a manner that provides reasonable assurance that personnel will understand and comply.¹⁷ Additionally, documentation should be prepared to demonstrate compliance with the firm's policies and procedures for the elements of quality control.¹⁸

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.¹⁹

Under QC 30, monitoring procedures should enable the firm to obtain reasonable assurance that its system of quality control is effective.²⁰ A firm's monitoring procedures may include:

- Inspection procedures;
- Preissuance or postissuance review of selected engagements;
- Analysis and assessment of:
 - New professional pronouncements;

¹⁵ See QC 20.08.

¹⁶ See QC 20.22.

¹⁷ See QC 20.23.

¹⁸ See QC 20.25.

¹⁹ See QC 30.02.

²⁰ See QC 30.03.

- 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.²¹

The nature and extent of monitoring procedures generally depends on the firm’s size and the nature and complexity of the firm’s practice.²² 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.²³

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 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.

²¹ See QC 30.03.

²² See, e.g., QC 30.05, .10, .11.

²³ See QC 30.09, .10.

- 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.²⁴

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.²⁵ Competencies are the knowledge, skills, and abilities that enable an engagement partner to be qualified to perform an engagement.²⁶ Competencies may be gained in various ways, including through relevant industry, governmental, and academic positions.²⁷ 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
- Understanding the organization's information technology systems.²⁸

²⁴ See QC 40.02.

²⁵ See QC 40.03.

²⁶ See QC 40.04.

²⁷ See QC 40.05.

²⁸ See QC 40.08.

Under QC 40, these competencies are interrelated.²⁹ 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.³⁰

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 the establishment of the PCAOB.

Under PCAOB rules, certain SECPS requirements still apply to firms that were members of the SECPS as of April 16, 2003.³¹ Based on current registration data, the SECPS member requirements apply to 201 (approximately 12% of) PCAOB-registered firms, including 11 of the 14 annually inspected firms in 2023.

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.³² Professionals who devote at least 25% of their time to performing audit, review, or other attest engagements, or who 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.³³

Additional information on Section 1000.08(d)'s CPE requirements appears in SECPS Section 8000, *Continuing Professional Education Requirements Effective for Educational Years*

²⁹ See QC 40.09.

³⁰ See QC 40.10.

³¹ 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.” The note to 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.” 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*.

³² See SECPS § 1000.08(d).

³³ See SECPS § 1000.08(d).

*Beginning After May 31, 2002.*³⁴ 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.³⁵ 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.³⁶ Periodic communication also must inform professional firm personnel that compliance with those principles is mandatory.³⁷

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.³⁸

³⁴ See SECPS § 1000.08(d) (referring, in a footnote, to Section 8000).

³⁵ See SECPS § 8000.

³⁶ 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.

³⁷ See *id.*

³⁸ 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 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.

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*.³⁹

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.⁴⁰ 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.⁴¹

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.⁴²

³⁹ See SECPS § 1000.08(n).

⁴⁰ See SECPS § 1000.45.01.

⁴¹ See *id.*

⁴² 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 policies⁴³ covering relationships with “restricted entities,” for example, relationships between the restricted entity and the member firm, its benefit plans, and its professionals.⁴⁴ These relationships include investments, loans, brokerage accounts, business relationships, employment relationships, proscribed services, and fee arrangements.⁴⁵ 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.⁴⁶

A senior-level partner should be designated to oversee the independence policies and maintain and communicate the restricted entity list.⁴⁷ 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.⁴⁸

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.⁴⁹

⁴³ PCAOB rules do not mandate that writings be paper-based. *See, e.g.*, paragraph .04 of AS 1215, *Audit Documentation* (audit documentation may be in the form of paper, electronic files, or other media).

⁴⁴ *See* SECPS § 1000.46 (requirement 1).

⁴⁵ *See id.*

⁴⁶ *See* SECPS § 1000.46 (requirements 4, 5, and 6).

⁴⁷ *See* SECPS § 1000.46 (requirement 5).

⁴⁸ *See* SECPS § 1000.46 (requirement 7).

⁴⁹ *See* SECPS § 1000.46 (requirement 3).

3. Observations from oversight activities

In the course of conducting inspections of registered public accounting firms⁵⁰ 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.⁵¹ Examples of changes firms have made in response to the Board's inspections include:⁵²

- *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

⁵⁰ The information on inspections and remediation efforts is limited to those firms that are subject to inspection by the PCAOB.

⁵¹ Additional information about the PCAOB remediation process is available on the PCAOB website at https://pcaobus.org/oversight/inspections/remediation/remediation_process.

⁵² 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 for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports*, PCAOB Rel. 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.⁵³ However, our inspections continue to identify deficiencies related to engagements and the operation of firm QC systems, suggesting that not all firms have made meaningful improvements in these areas. Moreover, the pervasiveness of recent findings regarding such deficiencies—both in terms of the number of firms affected and the percentage of deficient engagements—suggests that an updated QC standard is needed to drive proactive, systemic, and consistent improvements in audit quality rather than just case-by-case improvements in response to firm-specific findings.

The following discussion summarizes recent observations from our inspections⁵⁴ 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 final QC standard and related amendments, rules, and forms.

⁵³ See, e.g., *Spotlight: Staff Update and Preview of 2021 Inspection Observations* (December 2022) (“2021 Inspection Observations Preview”), at 20-22, available at https://assets.pcaobus.org/pcaob-dev/docs/default-source/documents/staff-preview-2021-inspection-observations-spotlight.pdf?sfvrsn=d2590627_4; *Staff Inspection Brief: Staff Preview of 2018 Inspections Observations* (May 6, 2019) (“2018 Inspection Observations Preview”), at 1-4, available at https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/inspections/documents/staff-preview-2018-inspection-observations.pdf?sfvrsn=b5f8cb09_0.

⁵⁴ 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.

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 2020 to 2022, the auditor's opinion was not adequately supported.⁵⁵ 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 professional standards in, among others, the areas of: (1) acceptance of engagements; (2) engagement performance; (3) independence, integrity, and objectivity; (4) personnel management; (5) monitoring; and (6) engagement quality reviews. Below, we provide examples of our observations in these areas.

i. Acceptance of engagements

A firm's QC system should provide the firm with reasonable assurance that it undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.⁵⁶ This includes taking into consideration, among other things, the availability of resources to perform an engagement and the competence of those resources. We have observed instances where a firm's lack of policies and procedures in the area of engagement acceptance and continuance resulted in accepting new engagements that were not completed with professional competence and resulted in numerous violations of PCAOB auditing standards.⁵⁷

⁵⁵ See Figure 1, Section VI.A.1, and accompanying text for an analysis of 2011-2022 inspections data.

⁵⁶ See QC 20.15.

⁵⁷ See, e.g., *In the Matter of WithumSmith+Brown, PC*, PCAOB Rel. No. 105-2024-010 (Feb. 20, 2024); *In the Matter of Jack Shama and Jack Shama, CPA*, PCAOB Rel. No. 105-2024-004 (Jan. 23, 2024); *In the Matter of Shandong Haoxin Certified Public Accountants Co., Ltd., LIU Kun, MA Yao, SUN Penghuan, and ZHU Dawei*, PCAOB Rel. No. 105-2023-045 (Nov. 30, 2023); *In the Matter of Alfonse Gregory Giugliano, CPA*, SEC Accounting and Auditing Enforcement Release ("AAER") No. 4458 (Sept. 12, 2023); *In the Matter of Marcum LLP*, PCAOB Rel. No. 105-2023-005 (June 21, 2023); *In the Matter of Marcum LLP*, SEC AAER No. 4423 (June 21, 2023).

ii. 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.⁵⁸ 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;⁵⁹
- Unwarranted reliance on data or reports used in testing an issuer's financial reporting controls or in substantive testing;⁶⁰
- Engagement partners' failure to adequately supervise the engagement with due professional care, which contributed to not identifying deficiencies;⁶¹
- Failure to implement and maintain adequate policies and procedures to provide reasonable assurance that work is performed and documented;⁶² and

⁵⁸ See QC 20.17.

⁵⁹ See, e.g., *WithumSmith+Brown, PC*, PCAOB Rel. No. 105-2024-010.

⁶⁰ See, e.g., *PKF O'Connor Davies, LLP*, PCAOB Rel. No. 105-2022-001.

⁶¹ See, e.g., *Alfonse Gregory Giugliano*, SEC AAER No. 4458; *In the Matter of Deloitte Touche Tohmatsu Certified Public Accountants, LLP*, SEC AAER No. 4342 (Sept. 29, 2022); *In the Matter of RSM*, SEC AAER No. 4346 (Sept. 30, 2022); *In the Matter of Mancera, S.C., Alejandro Valdez Mendoza, C.P., and Angel Radames Corral Nieblas, C.P.*, SEC AAER No. 4198 (Dec. 17, 2020); *In the Matter of Whitley Penn LLP, Susan Lunn Powell, CPA, Jeffrey Shannon Lawlis, CPA, and John Griffin Babb, CPA*, PCAOB Rel. No. 105-2020-002 (Mar. 24, 2020); *In the Matter of David M. Burns, CPA*, PCAOB Rel. 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 Rel. No. 105-2017-039 (Sept. 26, 2017); *In the Matter of KPMG LLP and John Riordan, CPA*, SEC AAER No. 3888 (Aug. 15, 2017).

⁶² See, e.g., *WithumSmith+Brown, PC*, PCAOB Rel. No. 105-2024-010; *In the Matter of SW Audit*, PCAOB Rel. No. 105-2024-009 (Feb. 20, 2024); *Jack Shama* PCAOB Rel. No. 105-2024-004; *In the Matter of Haynie & Company*, PCAOB Rel. No. 105-2024-001 (Jan. 23, 2024); *Shandong Haoxin Certified Public*

- Failure to ensure audits are performed under PCAOB standards and not another framework.⁶³

iii. 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.⁶⁴ Observations relating to auditor independence have been recurring over the last several years.⁶⁵ 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;⁶⁶

Accountants Co., Ltd., PCAOB Rel. No. 105-2023-045; *In the Matter of Deloitte & Touche S.A.S.*, PCAOB Rel. No. 105-2023-025 (Sept. 26, 2023); *Marcum LLP*, SEC AAER No. 4423; *Deloitte Touche Tohmatsu Certified Public Accountants, LLP*, SEC AAER No. 4342; *In the Matter of HLB Mann Judd, Darryl Swindells, and Aidan Smith*, PCAOB Rel. 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 Rel. No. 105-2019-028 (Oct. 31, 2019); *In the Matter of Deloitte Anjin LLC*, PCAOB Rel. No. 105-2019-025 (Oct. 31, 2019); *In the Matter of Deloitte Touche Tohmatsu Auditores Independientes*, PCAOB Rel. No. 105-2016-031 (Dec. 5, 2016).

⁶³ See, e.g., *In the Matter of Dale Matheson Carr-Hilton LaBonte LLP*, PCAOB Rel. No. 105-2021-021 (Dec. 14, 2021); *In the Matter of WDM Chartered Professional Accountants and Mike Kao*, PCAOB Rel. No. 105-2021-016 (Sept. 30, 2021).

⁶⁴ See QC 20.09.

⁶⁵ See, e.g., 2022 Inspection Observations Preview at 18; 2021 Inspection Observations Preview at 19; 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; *Spotlight: Staff Update and Preview of 2019 Inspection Observations* (Oct. 8, 2020) ("2019 Inspection Observations Preview"), at 7, available at <https://pcaobus.org/Inspections/Documents/Staff-Preview-2019-Inspection-Observations-Spotlight.pdf>; *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.

⁶⁶ 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. LLP*, PCAOB Rel. No. 105-2019-009 (Apr. 9, 2019); *In the Matter of Marcum LLP and Alfonse Gregory Giugliano, CPA*, PCAOB Rel. No. 105-2019-022 (Sept. 10, 2019); *In the Matter of Marcum Bernstein & Pinchuk LLP*, PCAOB Rel. 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;⁶⁷
- Noncompliance with PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*, and PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*;⁶⁸
- 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; and
- Failure to implement and maintain adequate policies and procedures to provide reasonable assurance that firm personnel timely consult on complex, unusual, or unfamiliar independence issues.⁶⁹

We also have observed highly concerning, widespread instances where firm personnel have improperly shared answers on examinations required to obtain or maintain professional licenses.⁷⁰ The Board has acted decisively in responding to this conduct, which was prevalent

⁶⁷ See, e.g., *In the Matter of Pricewaterhousecoopers LLP*, SEC AAER No. 4084 (Sept. 23, 2019); *In the Matter of RSM US LLP (f/k/a McGladrey LLP)*, SEC AAER No. 4066 (Aug. 27, 2019).

⁶⁸ See, e.g., *In the Matter of PricewaterhouseCoopers, S.C.*, PCAOB Rel. No. 105-2019-017 (Aug. 1, 2019); *In the Matter of BDO Magyarorszag Konyvvizsgalo Kft.*, PCAOB Rel. No. 105-2017-024 (Apr. 12, 2017).

⁶⁹ See, e.g., *In the Matter of PricewaterhouseCoopers LLP*, PCAOB Rel. No. 105-2024-014 (Mar. 28, 2024).

⁷⁰ See, e.g., *In the Matter of Navarro Amper & Co.*, PCAOB Rel. No. 105-2024-025 (Apr. 10, 2024); *In the Matter of Imelda & Rekan*, PCAOB Rel. No. 105-2024-024 (Apr. 10, 2024); *In the Matter of KPMG Accountants N.V.*, PCAOB Rel. No. 105-2024-022 (Apr. 10, 2024); *In the Matter of KPMG LLP (United Kingdom)*, PCAOB Rel. No. 105-2022-032 (Dec. 6, 2022); *In the Matter of Ernst & Young LLP*, SEC AAER No. 4313 (June 28, 2022); *In the Matter of PricewaterhouseCoopers LLP*, PCAOB Rel. No. 105-2022-002 (Feb. 24, 2022); *In the Matter of KPMG*, PCAOB Rel. No. 105-2021-008 (Sept. 13, 2021); *In the Matter of KPMG LLP*, SEC AAER No. 4051 (June 17, 2019).

both domestically and internationally.⁷¹ We have also observed instances where firm personnel have not acted with integrity by altering work papers⁷² or failing to cooperate with the Board.⁷³

These recurring deficiencies and violations suggest that some firms and their personnel either do not have the requisite understanding of applicable independence and ethics requirements, or, as evidenced by the systemic nature of certain of these violations, do not have appropriate controls in place to prevent violations.⁷⁴

iv. 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.⁷⁵ 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.⁷⁶ 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.⁷⁷

⁷¹ See, e.g., *In the Matter of PricewaterhouseCoopers Zhong Tian LLP*, PCAOB Rel. No. 105-2023-044 (Nov. 30, 2023); *In the Matter of PricewaterhouseCoopers*, PCAOB Rel. No. 105-2023-043 (Nov. 30, 2023); *KPMG LLP (United Kingdom)*, PCAOB Rel. No. 105-2022-032; *PricewaterhouseCoopers LLP*, PCAOB Rel. No. 105-2022-002; *KPMG*, PCAOB Rel. No. 105-2021-008.

⁷² See, e.g., *In the Matter of Jose Daniel Melendez Gimenez*, PCAOB Rel. No. 105-2022-035 (Dec. 6, 2022); *In the Matter of Edgar Mauricio Ramirez Rueda*, PCAOB Rel. No. 105-2022-036 (Dec. 6, 2022); *In the Matter of Marco Alexander Rodriguez Ramirez*, PCAOB Rel. No. 105-2022-037 (Dec. 6, 2022); *In the Matter of KPMG S.A.S.*, PCAOB Rel. No. 105-2022-034 (Dec. 6, 2022); *In the Matter of Jonathan B. Taylor, CPA*, PCAOB Rel. No. 105-2022-025 (Oct. 18, 2022); *Castillo Miranda y Compañía, S.C.*, PCAOB Rel. No. 105-2019-028; *Deloitte Anjin LLC*, PCAOB Rel. No. 105-2019-025; *Deloitte Touche Tohmatsu Auditores Independientes*, PCAOB Rel. No. 105-2016-031.

⁷³ See, e.g., *Shandong Haoxin Certified Public Accountants Co., Ltd.*, PCAOB Rel. No. 105-2023-045; *Jose Daniel Melendez Gimenez*, PCAOB Rel. No. 105-2022-035; *Edgar Mauricio Ramirez Rueda*, PCAOB Rel. No. 105-2022-036; *Marco Alexander Rodriguez Ramirez*, PCAOB Rel. No. 105-2022-037; *Jose Daniel Melendez Gimenez*, PCAOB Rel. No. 105-2022-035; *Castillo Miranda y Compañía, S.C.*, PCAOB Rel. No. 105-2019-028; *Deloitte Touche Tohmatsu Auditores Independientes*, PCAOB Rel. No. 105-2016-031.

⁷⁴ See 2021 Inspection Observations Preview at 19; 2019 Inspections Outlook at 2.

⁷⁵ See QC 20.12.

⁷⁶ See QC 20.13c.

⁷⁷ See QC 20.13a. and b.

We have observed deficiencies related to compliance with the firm’s auditing policies and procedures.⁷⁸ 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.⁷⁹

v. Monitoring

A firm’s QC system should provide the firm with reasonable assurance that its policies and procedures are suitably designed and effectively applied.⁸⁰ 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.⁸¹ These deficiencies and violations were subsequently identified through SEC and PCAOB oversight.⁸²

vi. Engagement quality reviews

Both the PCAOB and SEC have identified deficiencies and violations in audit areas that require evaluation by the engagement quality reviewer (“EQR”),⁸³ which suggests the EQR did

⁷⁸ See 2022 Inspection Observations Preview at 18.

⁷⁹ See, e.g., *Jack Shama* PCAOB Rel. No. 105-2024-004; *In the Matter of Hall & Company Certified Public Accountants & Consultants, Inc., and Anthony J. Price, CPA*, PCAOB Rel. No. 105-2022-029 (Nov. 3, 2022); *In the Matter of PKF O’Connor Davies, LLP*, PCAOB Rel. No. 105-2022-001 (Jan. 25, 2022); *WDM Chartered Professional Accountants* PCAOB Rel. No. 105-2021-016; *In the Matter of Grant Thornton LLP*, PCAOB Rel. No. 105-2017-054 (Dec. 19, 2017); *BDO Auditores, S.L.P.*, PCAOB Rel. No. 105-2017-039.

⁸⁰ See QC 20.20.

⁸¹ See, e.g., 2022 Inspection Observations Preview at 19.

⁸² See, e.g., *In the Matter of KPMG Assurance and Consulting Services LLP and Sagar Pravin Lakhani*, PCAOB Rel. No. 105-2022-033 (Dec. 6, 2022); *In the Matter of Friedman LLP*, SEC AAER No. 4339 (Sept. 23, 2022); *In the Matter of BMKR LLP and Joseph Mortimer, CPA*, PCAOB Rel. No. 105-2022-003 (Feb. 24, 2022); *PKF O’Connor Davies, LLP*, PCAOB Rel. No. 105-2022-001; *WDM Chartered Professional Accountants* PCAOB Rel. No. 105-2021-016; *In the Matter of Haskell & White LLP*, PCAOB Rel. No. 105-2021-006 (Aug. 13, 2021); *In the Matter of RBSM LLP*, PCAOB Rel. No. 105-2021-004 (Aug. 9, 2021); *Castillo Miranda y Compañía, S.C.*, PCAOB Rel. No. 105-2019-028; *Marcum LLP* PCAOB Rel. No. 105-2019-022; *Marcum Bernstein & Pinchuk LLP*, PCAOB Rel. No. 105-2019-023; *PricewaterhouseCoopers, S.C.*, PCAOB Rel. No. 105-2019-017; *In the Matter of Bharat Parikh & Associates Chartered Accountants, Bharatkumar Balmukund Parikh, FCA, and Anuj Bharatkumar Parikh*, PCAOB Rel. No. 105-2019-003 (Mar. 19, 2019); *Grant Thornton*, PCAOB Rel. No. 105-2017-054.

⁸³ See, e.g., *Spotlight: Inspection Observations Related to Engagement Quality Reviews* (October 2023), available at https://assets.pcaobus.org/pcaob-dev/docs/default-source/documents/eqr-spotlight.pdf?sfvrsn=95a345e6_4; 2022 Inspection Observations Preview at 19; 2021 Inspection Observations Preview at 20; 2018 Inspection Observations Preview, at 4; 2020 Inspection Observations Preview at 12.

not perform the evaluation with due professional care.⁸⁴ Additionally, for certain broker-dealer audit and attestation engagements, we have observed instances where engagement quality reviews were not performed or sufficiently documented⁸⁵ and policies and procedures did not provide reasonable assurance that engagement quality reviews were performed with due professional care.⁸⁶

b. Good practices observed from inspections

The following observations regarding good QC practices are based on inspections in recent years.⁸⁷ 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 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:

⁸⁴ See, e.g., *In the Matter of RAM Associates & Company LLC and Parameswara K. Ramachandran*, PCAOB Rel. No. 105-2023-021 (Aug. 8, 2023); *In the Matter of Total Asia Associates PLT*, PCAOB Rel. No. 105-2023-007 (Jun. 23, 2023); *In the Matter of RT LLP*, PCAOB Rel. No. 105-2023-002 (Apr. 11, 2023); *In the Matter of Donald R. Burke, CPA*, PCAOB Rel. No. 105-2021-012 (Sept. 29, 2021); *RBSM LLP*, PCAOB Rel. No. 105-2021-004; *In the Matter of Cheryl L. Gore, CPA and Stanley R. Langston, CPA*, PCAOB Rel. No. 105-2021-020 (Dec. 14, 2021); *Whitley Penn LLP*, PCAOB Rel. No. 105-2020-002; *In the Matter of Helen R. Liao, CPA*, PCAOB Rel. 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); *BDO Auditores, S.L.P.*, PCAOB Rel. No. 105-2017-039 .

⁸⁵ See, e.g., *In the Matter of Alvarez & Associates, Inc., Certified Public Accountants, and Vicente Alvarez, CPA*, PCAOB Rel. No. 105-2022-039 (Dec. 21, 2022); *In the Matter of Citrin Cooperman & Company, LLP, Joseph Puglisi, CPA, Mark Schniebold, CPA, and John Cavallone, CPA*, PCAOB Rel. No. 105-2022-007 (May 11, 2022).

⁸⁶ See *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers*, PCAOB Rel. No. 2023-005 (Aug. 10, 2023) ("2022 Broker-Dealer Inspection Report"), at 31.

⁸⁷ See, e.g., 2022 Inspection Observations Preview; 2021 Inspection Observations Preview; 2020 Inspection Observations Preview; 2019 Inspection Observations Preview; and 2018 Inspection Observations Preview.

- 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,⁸⁸ 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.⁸⁹

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 the 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

⁸⁸ See 2021 Inspection Observations Preview at 22; 2019 Inspection Observations Preview at 4.

⁸⁹ See 2018 Inspection Observations Preview at 2.

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;⁹⁰
- Formalized monitoring processes and actions for defined triggering events, including restatements, internal and external inspection results, and results of peer reviews; and
- 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

⁹⁰ See 2020 Inspection Observations Preview at 4, 13.

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 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.⁹¹ 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, culture, 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.⁹² However, as noted above, our oversight activities continue to identify pervasive deficiencies, suggesting that many firms have meaningful improvements to make.

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 control⁹³ and the International Organization for Standardization (“ISO”) quality control standard

⁹¹ See, e.g., the UK Financial Reporting Council, *Audit Firm Governance Code* (April 2022), 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, *Audit Firm Governance Code* (March 2017) available at <https://www.fsa.go.jp/news/28/sonota/20170331-auditfirmgc/3.pdf>.

⁹² See, e.g., 2018 Inspection Observations Preview at 1-4.

⁹³ 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/files/ugd/3059fc_1df7d5dd38074006bce8fdf621a942cf.pdf.

ISO 9000:2015.⁹⁴ 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.⁹⁵

C. Actions by Other Standard Setters

Following is a brief description of the quality control standards adopted by the IAASB and the AICPA.

1. IAASB

The IAASB identified concerns related to its then effective 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 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”),⁹⁶ which became effective on December 15, 2022.⁹⁷

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 Statement on Quality Management Standards (SQMS) No. 1, *A Firm’s System of*

⁹⁴ More information about ISO 9000:2015 is available at <https://www.iso.org/standard/45481.html>.

⁹⁵ See Section VI.C.1.a, Benefits of related frameworks.

⁹⁶ 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 operates at the firm level, and is analogous to PCAOB AS 1220, *Engagement Quality Review*. ISA 220 (Revised) operates 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*.

⁹⁷ ISQM 1 sets forth eight components of a QC system that operate in an iterative and integrated manner, as well as other requirements. 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>.

Quality Management (“SQMS 1”).⁹⁸ 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 AICPA standards will become effective on December 15, 2025.

D. PCAOB Outreach and Research

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 and implementing a QC system.⁹⁹ 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.¹⁰⁰ 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.¹⁰¹ Advisory group members have generally supported including requirements concerning firm governance and leadership in PCAOB QC standards.

E. Rulemaking History

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

⁹⁸ 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*.

⁹⁹ 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.

¹⁰⁰ 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.

¹⁰¹ 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.

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.¹⁰²

We received 36 comment letters in response to the concept release.¹⁰³ Commenters included firms and related groups, investors and related groups, academics, trade groups, and others.

On November 18, 2022, we issued a proposal to supersede current PCAOB QC standards with an integrated, risk-based standard, QC 1000, *A Firm's System of Quality Control*, that would apply to all registered firms. We received 42 comment letters in response to the proposal.¹⁰⁴ Commenters included firms and related groups, investors and related groups, academics, trade groups, and others. We have considered all comments in developing the final standard and related amendments, and commenter input is included where relevant in the discussion that follows.

F. Areas of Improvement to the QC Standards

Taking into account the foregoing considerations, as well as careful consideration of comments received, we are adopting changes to our QC standards that we believe will drive significant improvements in firms' QC systems, by:

- Emphasizing accountability, firm culture and the "tone at the top," and firm governance through requirements for specified roles within and responsibilities for the QC system, including at the highest levels of the firm; quality objectives that link compensation to

¹⁰² See Concept Release at 6.

¹⁰³ The comment letters received in response to the concept release are available on the Board's website in Docket 046.

¹⁰⁴ The comment letters received in response to the proposal are available on the Board's website in Docket 046. In addition to 42 letters received from commenters, Docket 046 includes an analysis prepared by the PCAOB Office of Economic and Risk Analysis.

quality; and, for the largest firms, the requirement of an independent perspective on firm governance;

- Striking the right balance between a risk-based approach to QC—which should drive firms to proactively identify and manage the specific risks associated with their practice—and a set of mandates, including mandatory quality objectives; mandatory processes for risk assessment, monitoring and remediation, and QC system evaluation; and specific requirements in key areas—which should assure that the QC system is designed, implemented and operated with an appropriate level of rigor;
- 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;
- Broadening responsibilities for monitoring and remediation of deficiencies to encourage an ongoing feedback loop that drives continuous improvement; and
- Requiring a rigorous annual evaluation of the firm’s QC system and related reporting to the PCAOB, certified by key personnel, to underscore the importance of the annual evaluation of the QC system, reinforce individual accountability, and support PCAOB oversight.

In our view, the basic objectives of the QC system should be the same for all firms, but the scope of the QC standard and how it applies should take into account wide disparities in nature and circumstances across registered firms, in particular the extent to which their practices include engagements required to be performed under PCAOB standards, and the complexity of such engagements. The risks that firms face, and therefore the specific policies and procedures necessary to appropriately serve investor interests through an effective QC system, vary significantly from the largest firms, operating as part of global networks, to local firms or sole proprietorships. The scalability of the new QC standard is discussed in greater detail in Section III.C. below.

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

A. Basic Structure

1. Considerations informing the structure of QC 1000

Informed by our observations and assessment of changes to auditing practice, we believe it is critical that our new QC standard strikes an appropriate balance between risk-based elements, which should drive firms to proactively identify and manage the specific risks associated with their practice, and a set of mandates to assure that the QC system is designed,

implemented, and operated with an appropriate level of rigor. Moreover, we believe the new QC standard should foster a proactive approach to QC that drives continuous improvement. Based in part on our observations, we also believe our new standard should include specific requirements for some important areas of the QC system that are addressed more generally in our current QC standards, such as firm governance and leadership, technology and other firm resources, and firm communications.

QC 1000 addresses all the areas of QC that Sarbanes-Oxley requires our QC standards to address, which we believe will provide a robust framework for a firm's QC system. It incorporates eight components, which are based on mandatory elements and mandatory processes that create a basic structure applicable to all firms. For example, as discussed in more detail below, QC 1000 establishes mandatory, outcome-based quality objectives and mandatory processes for risk assessment and monitoring and remediation. Within the structure created by these mandates, firms will develop their own policies and procedures based on the specific risks created by their circumstances and practice. QC 1000 also includes requirements for annual evaluation of the QC system and reporting to the PCAOB on that evaluation, which we believe will add rigor and accountability to the firm's evaluation of whether the QC system has met its objectives, and will strengthen the feedback loop that drives continuous improvement.

The structure itself addresses areas that our current standards do not directly address, such as firm governance and leadership, technology and other firm resources, and firm communications. In addition, to the extent it is principles-based and focused on the specific risks faced by the firm, the structure is inherently scalable and can be applied to firms of all sizes and circumstances.

The structure of QC 1000 has commonalities with the structure of ISQM 1 and SQMS 1. While the approach taken in ISQM 1 and SQMS 1 has informed our thinking, we have carefully analyzed every aspect of that approach and considered where to align and where to further strengthen our standard by including alternative or incremental provisions that we believe will better serve investor protection and the public interest. We believe that building on a well-understood basic framework, appropriately tailored and strengthened to address our legal and regulatory environment and our investor protection mandate, will enable firms to implement and comply with QC 1000 more effectively. 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 constitute a very substantial majority of firms that perform engagements under our standards¹⁰⁵—can leverage the work they have already done and the investments they have already made to comply with those other requirements.

¹⁰⁵ See Section VI.A.5 for a discussion of the assumptions regarding the baseline.

Many commenters, including firms and related groups, were generally supportive of structuring QC 1000 in a manner similar to the structure of ISQM 1 and SQMS 1. However, several commenters, including firms and related groups, suggested that further alignment should be considered, and any differences should be minimized. Several commenters suggested that firms would be subject to at least two different quality management/quality control systems, and commented that this would be impractical for firms to operate. We do not believe that QC 1000 conflicts with the requirements of other standard setters or that anything prevents firms from developing a single QC system for their entire practice that satisfies both PCAOB requirements and other professional standards to which the firm is subject. We acknowledge certain differences between QC 1000 and the quality management standards set by other standard setters, in particular areas where QC 1000 establishes additional or more stringent requirements. However, we believe that quality responses developed by firms under QC 1000 can be considered by firms for the purposes of other quality management standards to which they are subject, reducing the need for two or more separate QC systems.

One investor-related group did not support the framework of the standard, arguing that ISQM 1 is a process-driven and compliance-oriented framework that does not encourage firms to meaningfully enhance their QC systems for the benefit of investors. Another investor expressed concern regarding the reliance on ISQM 1 in the development of QC 1000 on the basis that it does not always reflect the best interests of investors. We continue to believe that a common basic structure among quality control standards is beneficial. This is not only cost beneficial, but it also supports a firm's ability to operate a single, consistent QC system over its whole practice, which we believe ultimately supports audit quality. Where appropriate, QC 1000 goes beyond ISQM 1 to incorporate more detailed or more stringent provisions that are specifically relevant to the U.S. regulatory environment and investors.

Several commenters supported a principles-based approach to QC 1000. However, some commenters suggested that the specified quality responses throughout the standard impose prescriptive requirements that are not consistent with maintaining a principles-based approach. Others expressed a different perspective, suggesting that the standard was too principles-based, providing the firms with too much flexibility in designing, implementing, and operating their QC systems. For example, an investor expressed concern that a principles-based approach does not always reflect the best interests of investors. Other investor-related groups expressed concerns that a principles-based approach allows audit firms to conduct their own risk assessment and design their own controls to manage risks, including making the determination of whether QC deficiencies exist and are remediated without any public awareness or accountability. One of these investor-related groups suggested that an emphasis on a risk-based approach will result in little to no change at the largest auditing firms as they believe that this approach is already embedded in their QC systems. Another investor-related group commented that the proposed standard set the bar too low and failed to focus on audit quality and accountability such that it would only perpetuate the status quo.

We have retained the approach as proposed. We believe that QC 1000 strikes the right balance between mandatory and risk-based elements. As discussed in more detail in Section III.A.3. below, QC 1000 establishes a mandatory minimum set of outcome-based quality objectives that apply to all firms. Firms generally cannot omit or modify any of the quality objectives set out in the standard. Therefore, firms do not determine the criteria by which their QC systems will be assessed, only the means by which they will meet those criteria. Moreover, QC 1000 establishes requirements with which all firms will have to comply for roles and responsibilities within the QC system and the firm's risk assessment process, monitoring and remediation process, and evaluation process, as well as specified quality responses applicable to all firms in areas that we believe justify a more prescriptive approach. It also includes evaluation and reporting requirements that we believe will add accountability and rigor to the annual evaluation.

Within that framework, QC 1000 requires firms to develop the policies and procedures they need to achieve the quality objectives and the overall objective of the QC system. We believe this more principles-based aspect of the standard will prompt firms to identify and focus on the most relevant risks to quality in the context of their own practice and will make QC 1000 appropriately scalable. This approach also allows for the standard to be operable by firms of all sizes. Smaller PCAOB audit practices can scale down their responses to fit the risks associated with a small practice, and as the practice grows, the firm can scale up to respond to new quality risks. In addition, we believe that this approach will make it less likely that the standard will need to be amended in the future in response to changes in the auditing environment, including the use of technology.

2. Components of the QC system

Under QC 1000, the QC system consists 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 engagements

- Engagement performance
- Resources
- Information and communication

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

- Establish outcome-based “quality objectives,” including those specified throughout the standard (i.e., the desired outcomes to be achieved by the firm with respect to that component),¹⁰⁶
- Identify and assess “quality risks” to the quality objectives;¹⁰⁷
- Design and implement “quality responses” (i.e., policies and procedures to address quality risks);¹⁰⁸ 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 applies to all of the components of the QC system, including monitoring and remediation itself (i.e., firms are required to identify 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.

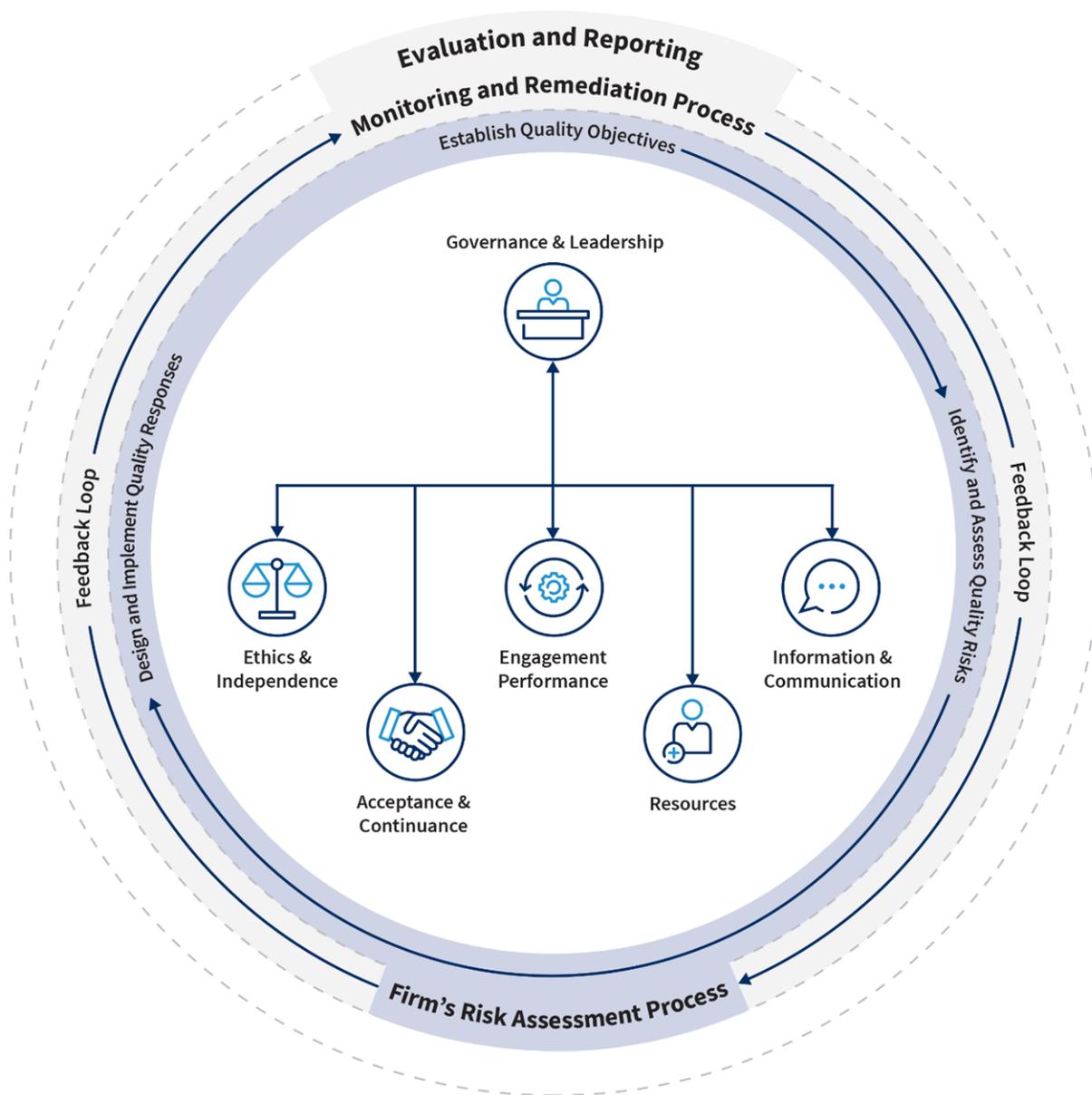
The following diagram illustrates the structure of the firm’s QC system under QC 1000:

¹⁰⁶ “Quality objectives” are defined in QC 1000.A10.

¹⁰⁷ “Quality risks” are defined in QC 1000.A12.

¹⁰⁸ “Quality responses” are defined in QC 1000.A11.

Structure of the Firm's QC System



3. Quality objectives, quality risks, and quality responses, including specified quality responses

For each of the six components to which the risk assessment process applies, QC 1000 specifies required quality objectives. While QC 1000 provides some flexibility with regard to the

quality risks that firms are required to identify and the quality responses that firms are required to develop to address those risks, it does not provide the same flexibility with regard to quality objectives. Instead, quality objectives that will apply to all firms are specified in the standard. Firms can establish additional quality objectives—indeed, they are required to do so if necessary to achieve the objective of the QC system—but they generally cannot omit or modify any of the quality objectives set out in the standard. We believe that, for many firms, the quality objectives specified in the standard are likely to 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 are required to establish additional quality objectives, if necessary.¹⁰⁹ The quality objectives established by this standard set forth a floor rather than a ceiling.

Firms are required to identify and assess quality risks to the achievement of the established quality objectives. They are required to develop quality responses to address the assessed quality risks. Quality responses are defined as policies and procedures designed and implemented by the firm to address quality risks; policies are statements of what should, or should not, be done to address an assessed quality risk, and procedures are actions to implement and comply with policies. As proposed, the definition of quality responses provided that policies “may be documented or explicitly stated in communications.” In the final rule, we have eliminated that sentence to avoid confusion or potential conflict with the documentation requirements set out in QC 1000.81-83.

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. QC 1000 also includes some specified quality responses, which are mandatory for the firms to which they apply. Specified quality responses carry requirements from our current standards into QC 1000 or provide new requirements that we believe are important to a firm’s 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 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 will not be sufficient to enable the firm to achieve all established quality objectives; firms are 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 are critical in addressing

¹⁰⁹ See Section IV.D, The Firm’s Risk Assessment Process.

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 QC 1000:

The Relationship Between Quality Responses and Specified Quality Responses



B. Terminology

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

Two commenters indicated that our proposed terminology was understandable and appropriate, but most commenters on the topic requested that the terminology used in QC 1000 be consistent with the terminology used by other standard setters, primarily to avoid potential confusion and ensure that the process of evaluating the QC system and the conclusion reached as to its effectiveness would be the same under both standards. We continue to believe that our proposed terminology is necessary to capture the basic concepts used in

QC 1000, which differ in some respects from the concepts used by other standard setters, particularly as regards “other participants,” as we have defined that term, and the annual QC system evaluation process, which is grounded in the concepts of “engagement deficiency,” “QC deficiency,” and “major QC deficiency.” While this approach will result in an incremental burden for firms that seek to comply with other QC standards as well as QC 1000, we believe that the burden is justified. We also believe that, just as firms can perform audits under different auditing standards, they can learn to implement and operate a QC system under different QC standards. Accordingly, with the clarifications described below, we are adopting the terminology substantially as proposed.

1. Applicable professional and legal requirements

As discussed in more detail in Section IV, compliance with applicable professional and legal requirements is a fundamental concept under QC 1000, driving the objective of the QC system as well as many quality objectives and specified quality responses. The proposed standard defined “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.

Two commenters supported the definition as proposed. One commenter recommended including the profession’s ethical standards explicitly. Two commenters stated the phrase “other applicable statutory, regulatory, and other legal requirements” could be read broadly and extend beyond regulations that directly bear on the conduct of audit engagements. Another commenter suggested amending the definition of “professional standards” in PCAOB Rule 1001(p)(vi) to refer to “quality control standards” rather than “quality control policy and procedures.”

In response to comments, we have made changes to the third, more general clause of the definition. As one commenter suggested, we have expanded the definition to explicitly mention ethics laws and regulations.¹¹⁰ While the definition as proposed encompassed applicable ethics requirements, we believe an express reference will help to remind firms and individuals of the centrality of ethics considerations. We have also refined the definition to make clear that it encompasses statutory, regulatory, and other legal requirements beyond

¹¹⁰ These include those arising under state law or the law of other jurisdictions (e.g., obligations regarding client confidentiality). See QC 1000 footnote 10.

professional standards and other PCAOB rules “[t]o the extent related to the obligations and responsibilities of accountants or auditors in the conduct of *engagements* or in relation to the QC system.” This change is designed to limit the breadth of the definition to the relevant circumstances.

The phrase “quality control policies and procedures,” used in PCAOB Rule 1001(p)(vi), is drawn from Section 110(5) of Sarbanes-Oxley. We believe our rule should continue to align with that statutory provision.

This definition captures 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), applicable ethics law and rules, and other legal requirements related to the obligations and responsibilities of accountants or auditors in the conduct of the firm’s engagements or in relation to the QC system.¹¹¹ It does not encompass requirements that apply to businesses generally, such as tax laws, safety regulations, and employment law.

2. Engagement

The proposed standard defined “engagement” as (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).¹¹² In the final standard, the term “engagement” encompasses the same scope as it did in the proposal—when the firm leads an engagement as lead auditor or practitioner, or plays a substantial role—but the definition has been restructured for clarity.

¹¹¹ For avoidance of doubt, the 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 requirement does not suggest that application of “other applicable statutory, regulatory, and other legal requirements” could supersede rules of the 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.

¹¹² 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 final standard defines “engagement” as any audit, attestation, review, or other engagement performed under PCAOB standards:

- Led 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).

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 view is that this additional breadth is appropriate because playing a substantial role in an engagement for an issuer or broker-dealer 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.

Commenters on the definition of “engagement” generally supported it. One commenter requested clarification as to why the definition does not include work performed at less than a substantial role, given that the standard includes requirements regarding such work.

We have defined “engagement” to exclude work performed on other firms’ PCAOB engagements at less than a substantial role because we believe the auditor responsibilities associated with such work, and the risks posed by it, are materially different than the responsibilities and risks associated with a firm leading an engagement or playing a substantial role.¹¹³ QC 1000 contains provisions specifically applicable to work performed on other firms’ PCAOB engagements at less than a substantial role, which have been tailored to reflect those responsibilities and risks. We believe this tailored approach is appropriate.

Also grounded in our views on relative risk and the investor interests at stake, the concept of “engagement” marks an important distinction in the level of responsibility created under QC 1000: while all registered firms are required to design a QC system that complies with QC 1000, the 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 QC 1000 (for firms that do not

¹¹³ Our registration rules reflect this difference in risk profile: PCAOB registration is required for firms that lead engagements or play a substantial role in audits of issuers and broker-dealers, but not for work performed on other firms’ engagements at less than a substantial role. See PCAOB Rule 2100, *Registration Requirements for Public Accounting Firms*.

have responsibilities with respect to engagements) and full applicability of QC 1000 (for firms that do perform engagements) is discussed in more detail in Section III.C below.

We note, however, that just because work performed on other firms' PCAOB engagements at less than a substantial role is not considered an "engagement" does not mean it is disregarded under the QC system. This work, by itself, does not trigger the requirement to implement and operate the QC system under QC 1000. However, once a firm is required to implement and operate the QC system, the system will operate over all work performed by the firm under PCAOB standards, including work performed on other firms' PCAOB engagements at less than a substantial role. 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. Firm personnel

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

Two commenters agreed with the definition as proposed. Some firms and related groups objected to including non-employee contractors and consultants as firm personnel, in particular because they are not subject to the firm's performance evaluation or promotion process. These commenters suggested that such persons be classified as other participants instead. One commenter expressed concern about potential exposure due to the differences between QC 1000 and the definitions of employees with federal, state, and local tax and labor laws.

We continue to believe it is appropriate for the definition of firm personnel to include 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. In light of the range of legal structures and arrangements used by firms in acquiring and deploying staff, we believe a definition based exclusively on legal employment would be too narrow. Instead, the final rule retains an approach based on the functional role played by the individual rather than a specific legal relationship.

When the firm is identifying quality risks to quality objectives that include firm personnel, it may identify different risks associated with non-employee contractors and consultants than other firm personnel, and accordingly would have to develop different policies

and procedures for them. For example, non-employee contractors and consultants may be evaluated through the contracting process to determine whether the firm should retain them instead of through the firm's formal evaluation framework.

While we express no view on any tax or labor law consequences, we note that our definition does not conflate "firm personnel" with employees. On the contrary, it acknowledges that firm personnel includes some non-employees.

Some commenters, generally firms and related groups, were opposed to the definition including anyone who "assists with" engagements or the quality control system, as it may include administrative staff. We have revised the definition of firm personnel to clarify that "professional staff does not include persons engaged only in clerical or ministerial tasks," which aligns with the definition of "Person Associated With a Public Accounting Firm (and Related Terms)" in PCAOB Rule 1001(p)(i).¹¹⁴

4. 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. In the context of amending the standards governing the involvement of other auditors in an audit, we 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.¹¹⁵ 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).

With respect to work performed in connection with the firm's QC system or the performance of its engagements, QC 1000 defines "other participants" as accounting firms (foreign or domestic, registered or unregistered), accountants, and other professionals¹¹⁶ or organizations, other than firm personnel, whose responsibilities include assisting with the

¹¹⁴ By aligning the QC 1000 definition of "firm personnel" with the definition of "Person Associated with a Public Accounting Firm (and Related Terms)" in this regard, we do not mean to suggest that only "firm personnel" can be associated persons. "Other participants" can also be associated persons.

¹¹⁵ See *Planning and Supervision of Audits Involving Other Auditors and Dividing Responsibility for the Audit with Another Accounting Firm*, PCAOB Rel. No. 2022-002 (June 21, 2022), at 13; *Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*, PCAOB Rel. No. 2018-006 (Dec. 20, 2018), at 10-15.

¹¹⁶ In this context, "professionals" refers broadly to workers who perform other than clerical or ministerial tasks.

performance of the firm’s engagements or the design, implementation, or operation of the firm’s QC system, including engagement quality reviews.¹¹⁷

Some commenters expressed concerns with the use of “other participants” throughout the standard. Many commenters said the proposed responsibilities of the firm with regard to other participants were too broad. A few commenters suggested removing the reference to other participants from certain specified quality responses and allowing firms to tailor their responses to quality objectives for other participants. Some commenters were specifically concerned about the inclusion of internal auditors and external specialists in the standard through other participants, and believe they are adequately addressed in other standards. Some commenters argued that other participants should not be included in another firm’s quality control system because they are covered by their own firm’s quality control system.

Some commenters suggested bifurcating the definition into other participants whose responsibilities include assisting with the performance of the firm’s engagements and other participants whose responsibilities include assisting with the design, implementation, and operation of the firm’s QC system, on the basis that this would enhance clarity regarding to whom the requirements apply. One commenter said the policies and procedures related to other participants would differ depending on the type of other participant (for example, an internal auditor providing direct assistance differs from an auditor, specialist, or engagement quality reviewer) and QC 1000 imposes the same requirements for each type. One commenter supported the definition. One commenter agreed with separately defining “other participants” and “third-party providers.”

The final standard reflects our view that, in designing, implementing, and operating its QC system, the firm will have to address not only firm personnel but also other auditors¹¹⁸ and other professionals or organizations that the firm uses in connection with the firm’s QC system or the performance of its engagements. We have included references to other participants throughout QC 1000 in a tailored and context-specific way that recognizes the key roles that other participants play.

We recognize that some other participants may be covered by their own firm’s quality control system, and that fact may inform the firm’s risk assessment with respect to their participation. But the firm’s own QC system must address all the work done on the firm’s

¹¹⁷ It should be noted that “referred-to auditors,” as that term is defined in the amendments to AS 2101, *Audit Planning*, adopted in PCAOB Rel. No. 2022-002, are not “other participants” under QC 1000 because the referred-to auditor performs its own engagement and does not participate in the engagement of the lead auditor.

¹¹⁸ See AS 1205, *Part of the Audit Performed by Other Independent Auditors*, and AS 1201 (which takes effect for audits of financial statements for fiscal years ending on or after December 15, 2024).

engagements and in connection with the design, implementation, and operation of the firm's QC system itself, regardless of who does it.

Commenters correctly pointed out that specific performance standards exist related to the use of certain types of other participants in an audit, such as other auditors,¹¹⁹ internal auditors,¹²⁰ and specialists,¹²¹ but that does not mean that QC over their use in the firm's engagements is unnecessary. In part, the QC system operates to assure compliance with those specific audit standards. But it must also provide more general assurance about the performance of audits in which those types of other participants are involved. For example, we expect that the firm's policies and procedures would cover, if applicable, engaging specialists, determining their compliance with ethics and independence requirements, and communicating with them as part of the firm's quality control system.

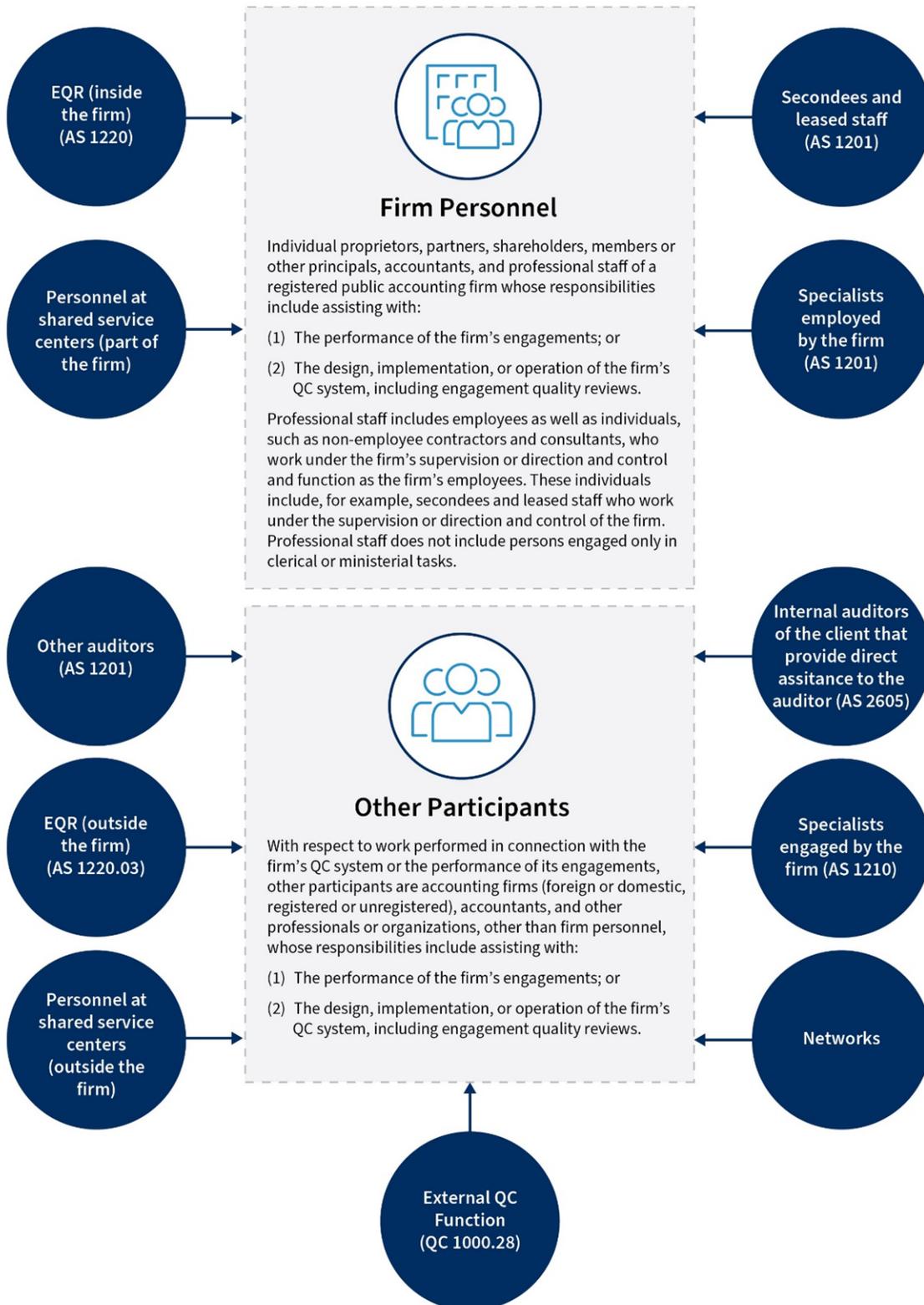
We do not believe it is necessary for QC 1000 to bifurcate other participants between those that participate in engagements and those that are involved with the QC system. Just because a quality objective or other provision of QC 1000 refers to all types of other participants in the same way does not mean that the firm should respond by treating all types of other participants in the same way. On the contrary, the firm's policies and procedures addressing other participants should differentiate based on the types and roles of other participants to the extent necessary to be responsive to the firm's quality risks. When designing quality responses, the firm will address the specific risks posed by the other participants and their responsibilities within the firm's engagements and QC system. For example, a firm that uses a network as a resource in many areas, such as independence tracking and monitoring, engagement performance, information and communication, and monitoring and remediation, would have many quality risks and quality responses related to their use of the network. A smaller firm that only uses one individual from outside the firm as an engagement quality reviewer may have fewer quality risks and quality responses related to other participants to address in its quality control system.

The following diagram provides QC 1000's definitions of "firm personnel" and "other participants" and provides examples of each type:

¹¹⁹ See, e.g., AS 1201, and AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*.

¹²⁰ See, e.g., AS 2605, *Consideration of the Internal Audit Function*.

¹²¹ See, e.g., AS 1210, *Using the Work of an Auditor-Engaged Specialist*.



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 personnel of another organization, such as a network affiliate).

5. Networks

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 administrative 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," QC 1000 describes these types of arrangements in more general terms.¹²²

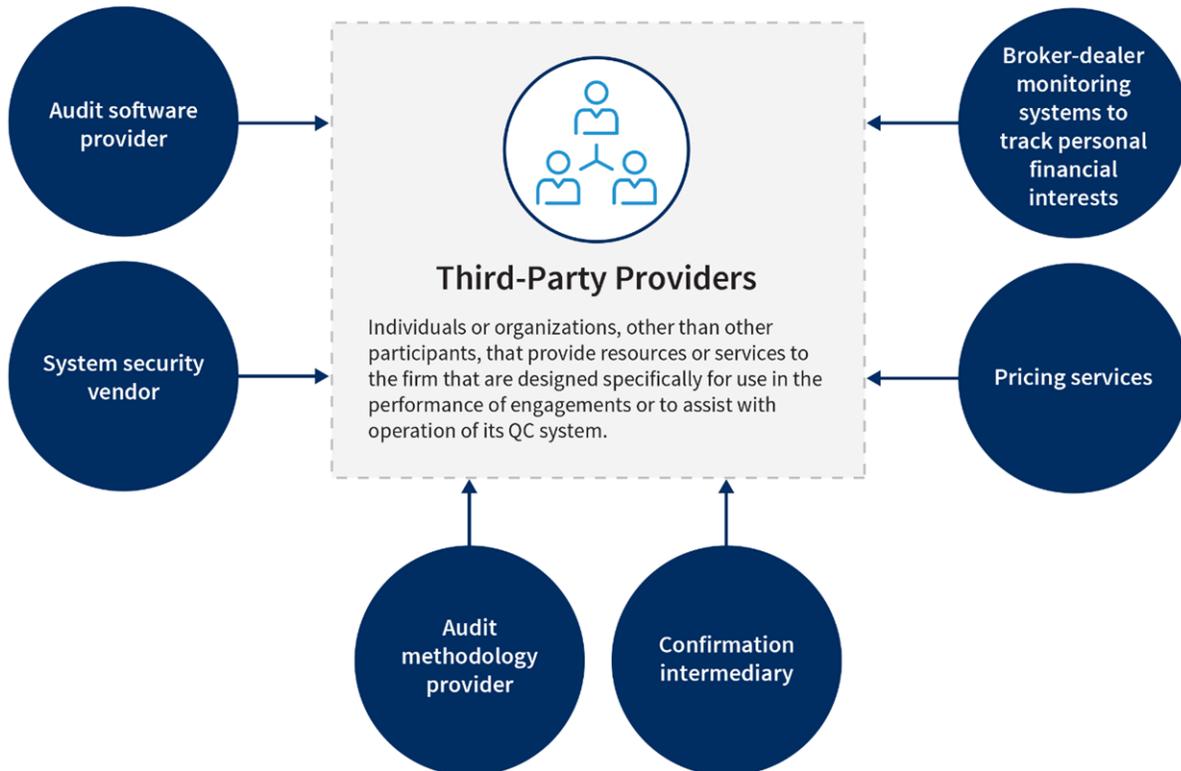
¹²² In the standard, references to a "network" encompass all of the memberships and affiliations that registered firms must report to us in Item 5.2 of their annual report on Form 2, including certain networks, arrangements, alliances, partnerships, and associations. See Item 5.2, PCAOB Form 2 (describing reporting requirements for memberships, affiliations, and similar arrangements).

Under the standard, networks may include a combination of registered and unregistered accounting firms and other entities.

6. Third-party providers

Commenters on this topic supported the definition of third-party providers as proposed.

The 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.¹²³ The following diagram provides QC 1000’s definition of “third-party providers” and several examples of them:



¹²³ 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) are not “third-party providers” as we have defined that term.

C. Scalability

The approximately 1,600 firms registered with us differ significantly based on their nature and circumstances:

- Approximately 53% of firms are located in foreign jurisdictions, representing 89 foreign jurisdictions;
- Approximately 20% of total firms, and 40% of firms located in foreign jurisdictions, belong to one of six global networks that contain the largest number of registered, non-U.S. firms that share resources such as methodology and monitoring activities¹²⁴;
- Approximately 60 firms are sole proprietorships;
- Approximately 650 firms, or 41% of firms, performed an engagement under PCAOB standards for an issuer or broker-dealer during the 12 months ended June 2023;
 - Approximately 70 only played a substantial role in such engagements in the past year;
 - Approximately 140 performed audits of only broker-dealers in the past year;
- Approximately 130 firms that did not perform an engagement under PCAOB standards for an issuer or broker-dealer in 2022 did perform such an engagement in the past five years; and
- Approximately 51% of firms have not performed an engagement under PCAOB standards for an issuer or broker-dealer in the past five years.¹²⁵

¹²⁴ The six global networks that contain the largest number of registered, non-U.S. firms as reported on Form 2s filed in 2023 are: BDO International Limited, Deloitte Touche Tohmatsu Limited, Ernst & Young Global Limited, Grant Thornton International Limited, KPMG International Cooperative, and PricewaterhouseCoopers International Limited (the member firms of these networks are collectively referred to herein as “GNFs”).

¹²⁵ The data were 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 be engaged, 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.

While we believe the basic objectives of the QC system ought to be the same across all firms, we believe the QC standard needs to be appropriately scalable, so that firms of different sizes and characteristics can appropriately design their QC system to address the risks associated with their own practice.

The specific policies and procedures necessary to achieve the objectives of the QC system may vary significantly across firms, depending on their size, the types of engagements they perform, and other factors. We believe that QC 1000 is sufficiently principles-based and scalable that firms will be able to pursue an approach to QC that is appropriate in light of their specific circumstances.

In our view, firms that perform engagements under PCAOB standards should generally be subject to the same QC 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 are eliminating that distinction. As discussed in more detail below, QC 1000 incorporates certain SECPS requirements, making them applicable to all firms, and eliminates others. However, we also believe there are specific areas, such as firm governance, where firms with larger PCAOB audit practices should be subject to enhanced requirements. QC 1000 includes several requirements that apply only to the firms that meet the statutory threshold for annual PCAOB inspection.

We are aware that there is a significant number of registered firms that do not perform engagements under PCAOB standards every year—they only participate in other firms' engagements at less than the level of a substantial role or have no involvement in issuer or broker-dealer engagements. We believe that the risk to investor protection is minimal if the firm is not performing engagements under PCAOB standards for issuers and SEC-registered broker-dealers, and that it is appropriate to provide for more limited QC obligations in those circumstances. Under QC 1000, all registered firms are required to design a QC system but only firms that are subject to applicable professional and legal requirements with respect to a PCAOB engagement are required to implement and operate the QC system.

1. Scaled applicability vs. full applicability

We have created a fundamental distinction in QC 1000 between the obligation to design a QC system in compliance with the standard, which will apply to all firms,¹²⁶ and the obligation to implement and operate an effective QC system, which, broadly speaking, will apply only to firms that perform engagements under PCAOB standards.

¹²⁶ QC 1000.06, discussed in Section IV.B below, sets out the requirements for QC system design.

Under the standard, firms are required to implement and operate an effective QC system—that is, comply with all provisions of 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.¹²⁷

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. In our view, whenever a firm has responsibilities under applicable professional and legal requirements with respect to an engagement, those responsibilities should be performed under a QC system that is implemented, is operating, and complies with PCAOB standards.

Importantly, if a firm is required to implement and operate an effective QC system, the firm would not necessarily have to implement and operate every QC policy or procedure that it has designed. An effective QC system provides reasonable assurance that the firm is complying with “applicable” professional and legal requirements. The extent of “applicable” requirements could change depending on the firm’s circumstances, and the QC system 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 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.¹²⁸ 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. We asked in the proposing release whether it was 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, and commenters that responded on the issue were generally supportive.

If the firm has no more responsibilities with respect to any engagement, the firm is required to continue operating the QC system until the next September 30 (the annual

¹²⁷ QC 1000.07.

¹²⁸ See AS 1215; Regulation S-X Rule 2-06, 17 C.F.R. § 210.2-06.

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.¹²⁹

Firms that are not subject to the requirement to implement and operate the QC system are still subject to the requirement to design a QC system that complies with QC 1000.¹³⁰ Paragraph .06 of QC 1000, discussed in Section IV.B below, sets out the requirements for design of the QC system in more detail.

We believe it is 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 standard defines that term, implementation and operation of a QC system would be largely hypothetical. Moreover, the population of firms that are subject only to the design requirements of QC 1000 is comprised entirely of firms that are not required to be registered with the PCAOB— because they do not participate in engagements under PCAOB standards or do so only below the level of a substantial role.¹³¹

Many commenters, including firms and related groups, investor-related groups, academics, and others, did not support requiring firms that are not required to comply with applicable professional and legal requirements to design a QC system under QC 1000. Several of these commenters expressed concerns that this would be unnecessarily costly to those firms, or suggested that there could be challenges associated with implementing and operating a QC system based on hypothetical risks that could differ from the actual risks at the time the firm accepts and performs engagements pursuant to PCAOB standards. Some commenters suggested that this requirement may cause firms to deregister with the PCAOB, decline to assist U.S. firms in executing their global audits, or create a potential barrier to entry for new firms in the marketplace. One firm-related group commented that as this aspect of the proposal affects such a large number of firms, the potential political impacts deserve further consideration. The firm-related group further commented that foreign firms could see this as an accelerator to a

¹²⁹ QC 1000.07. The proposed requirements for evaluation of and reporting on the QC system are discussed in Section IV.L below.

¹³⁰ The 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.

¹³¹ If a firm requests leave to withdraw from PCAOB registration and is permitted to do so, the firm, upon its withdrawal from registration, would no longer be subject to an obligation to design, implement, or operate a QC system in accordance with QC 1000.

decision to not service specific audit markets, which potentially impacts audit markets beyond the U.S., and that policy makers in other countries may view the potential for further market concentration more significantly.

Firms and a related group raising cost concerns with the proposed QC system design requirements suggested allowing firms that do not perform engagements the flexibility to design their QC system in accordance with another QC standard, such as ISQM 1 or SQMS 1. One of these firms further suggested that firms transitioning to performing engagements under PCAOB standards be given an additional six months to one year from their annual evaluation date to file their Form QC for the transition period. The firm asserted that even if a firm has complied with the design requirements, implementing and operating a QC system that complies with the standard would involve significant effort. Another firm suggested that it would be more appropriate to have a transition period for the registered public accounting firm to update their system of quality control to adhere to the incremental requirements of the PCAOB. An academic suggested that the design requirements for firms that have not performed and do not plan to perform engagements pursuant to PCAOB standards should be limited to client acceptance components. One firm suggested that the standard could include a requirement that firms are not allowed to perform an engagement under PCAOB standards until they have designed and implemented QC 1000. Other commenters suggested that registered firms that do not intend to conduct PCAOB audits should not be required to do anything under QC 1000.

Other commenters suggested a variety of approaches for when firms should be required to implement and operate a QC 1000-compliant QC system. One firm suggested that firms that only perform a substantial role in more than a certain threshold (presumably to be specified by the PCAOB) of PCAOB engagements could be permitted to comply with ISQM 1 instead of being subject to full applicability of QC 1000. Another commenter suggested that smaller firms (e.g., triennially inspected firms with fewer than 100 issuer engagements) be permitted the option of complying with ISQM 1 or SQMS 1 as an alternative to QC 1000. Another firm suggested that the PCAOB should permit non-US firms to comply with ISQM 1 rather than adopting QC 1000. Another commenter suggested that the criteria for full applicability of the standard should be based on whether the engagements individually or in the aggregate involve a material amount of market capitalization. The commenter suggested that under such an approach, the requirement to operate the QC system could be optional for registered firms auditing companies with a smaller market capitalization.

Some commenters, including a firm, a firm-related group, and an investor, commented that the requirement to design a QC 1000-compliant QC system is appropriate for any registered firm, even if it is not performing engagements or playing a substantial role in other firms' engagements. One firm-related group agreed 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. However, the commenter asked for clarification on the circumstances that trigger the need for a firm to implement and operate a QC system in compliance with QC 1000, and suggested targeted guidance in that area would be helpful.

We continue to believe that requiring all registered firms to design a QC system that complies with the 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 related to numerous topics for “every” registered public accounting firm.¹³² 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.”¹³³ 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,”¹³⁴ and that description must provide an overview of the applicant’s quality control policies regarding each element of quality control.¹³⁵ Therefore, firms that register with the Board are already required to provide a summary of the design of their QC system regardless of whether they have obligations with respect to engagements.¹³⁶

We also believe that requiring all firms to design a QC system that complies with all provisions of QC 1000, and not just limiting the requirement to certain components such as acceptance and continuance of engagements, is consistent with our investor protection mandate. While we acknowledge that there could be challenges associated with implementing and operating a QC system based on hypothetical risks, we continue to believe that it is important for registered firms to design a QC system based on the quality risks the firm likely would face if it were to perform engagements. Because registering with the PCAOB enables a firm to issue audit reports or play a substantial role on audits performed under PCAOB

¹³² Section 103(a)(2)(B) of Sarbanes-Oxley, 15 U.S.C. § 7213(a)(2)(B).

¹³³ Section 102(b)(2)(D) of Sarbanes-Oxley, 15 U.S.C. § 7212(b)(2)(D).

¹³⁴ Item 4.1 of PCAOB Form 1 (“Applicant’s Quality Control Policies”). We are modifying the information about QC required in Form 1. See Section V.C.7 below.

¹³⁵ See *Frequently Asked Questions Regarding Registration with the Board*, PCAOB Rel. 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. As part of this rulemaking the requirements in Form 1 are being amended.

¹³⁶ In a separate rulemaking, we have proposed to create a new form, Form QC – Policies and Procedures (“Form QCPP”), to require that, once QC 1000 becomes effective, any firm that registered with the Board prior to the date that QC 1000 becomes effective must submit an updated statement of the firm’s quality control policies and procedures pursuant to QC 1000. See *Firm Reporting*, Rel. No. 2024-003 (Apr. 9, 2024) at 41.

standards for issuers and broker-dealers, and because investors and companies considering engaging the firm 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 promotes our mission of protecting investors and promoting the public interest.

As discussed in more detail in Section IV, QC 1000 includes requirements that do not appear in other QC standards or that are more prescriptive or more specifically tailored to our legal and regulatory environment than the provisions of ISQM 1 or SQMS 1. Because of these key differences, we do not believe that a QC system design based on ISQM 1 or SQMS 1, as suggested by some commenters, would be sufficient. Furthermore, we believe that compliance with ISQM 1 may not be the regulatory baseline within certain jurisdictions. We have observed other standard setters and regulators adopt variations of ISQM 1, which typically include more detailed and stringent requirements.¹³⁷ Therefore, we believe that audit firms within some jurisdictions will already have to design and operate a QC system that goes beyond the requirements of ISQM 1, and it would not be appropriate for us to permit compliance with a less stringent quality system than the one required in the local regulatory environment. Similarly, we do not believe that it would be appropriate for us to permit firms to comply with their locally applicable variation of ISQM 1 as this would result in us requiring and managing compliance with a multitude of different QC standards.

We also continue to believe that, whenever a firm has responsibilities under applicable professional and legal requirements with respect to a firm engagement, those responsibilities should be performed under a QC system that is implemented, is operating, and complies with PCAOB standards. Given the unique features of QC 1000, compliance with ISQM 1 or SQMS 1 would not, in our view, be an adequate substitute, nor would our regulatory purposes be served by providing firms with an extended compliance period after they take on an engagement.

We do not believe that this requirement will result in disruption to competition in the audit market. Firms that are subject to applicable professional and legal requirements with respect to engagements, including substantial role engagements, are required to implement and operate a QC 1000-compliant QC system. If a registered firm that has not led an engagement or played a substantial role in the past anticipates the possibility of transitioning to performing engagements, we believe the requirement to design a QC system that complies with QC 1000 will facilitate timely implementation and operation of their QC 1000 QC system, which will in turn facilitate appropriate performance of the engagements; appropriate monitoring and, if necessary, remedial action; and timely evaluation and reporting on Form

¹³⁷ See, e.g., *International Standard on Quality Management (UK) 1*, adopted by the Financial Reporting Council (March 2023).

QC.¹³⁸ QC 1000 shares a basic structure and approach with ISQM 1 and SQMS 1, so designing for the incremental features unique to QC 1000 should not be unduly burdensome for firms that are subject to either or both of those other QC standards (which we believe will be the case for a very substantial majority of firms that are in a position to perform PCAOB engagements).¹³⁹

We do not believe that QC 1000 conflicts with the requirements of other standard setters or that anything prevents firms from developing a single QC system for their entire practice that satisfies both PCAOB requirements and other professional standards to which the firm is subject. We acknowledge certain differences between QC 1000 and the quality management standards set by other standard setters, in particular areas where QC 1000 establishes additional or more stringent requirements. However, we believe that quality responses developed by firms under QC 1000 can be considered by firms for the purposes of other quality management standards to which they are subject, reducing the need for two or more separate QC systems.

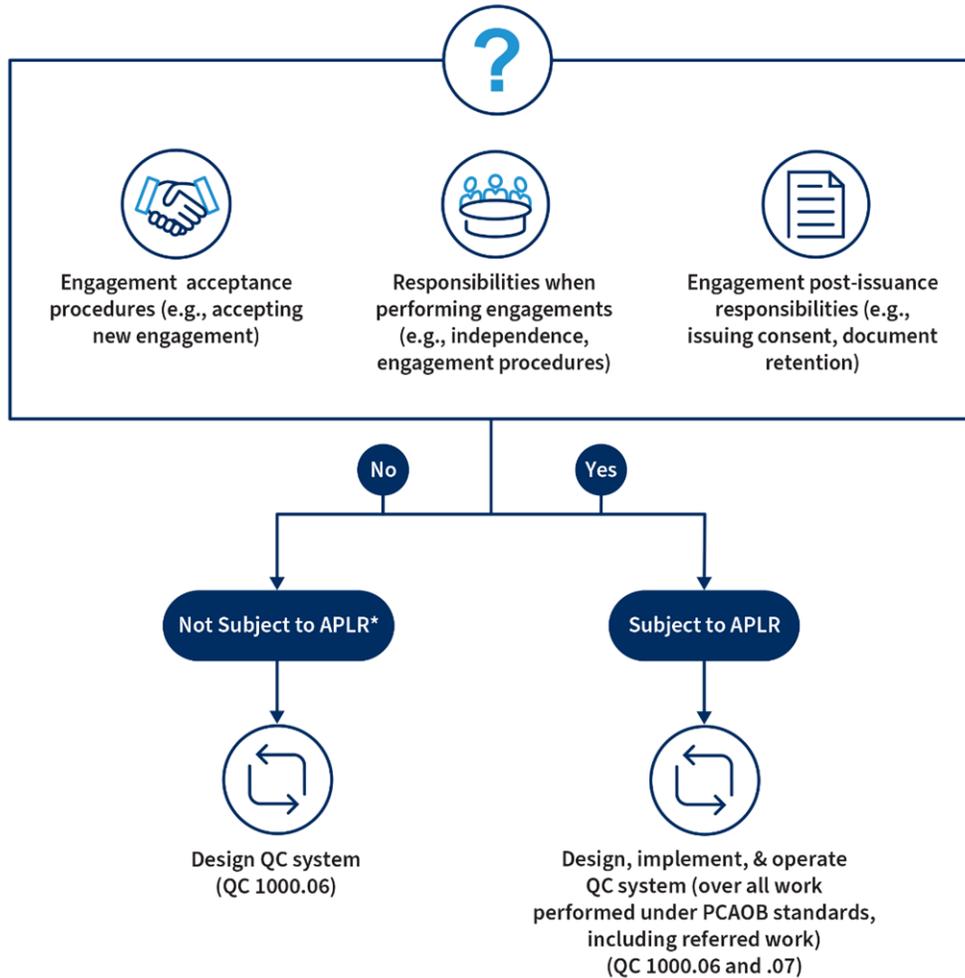
Firms participating in a PCAOB engagement below the level of a substantial role do not require registration with the PCAOB. If such a firm does not lead and does not plan to lead engagements or play a substantial role in engagements pursuant to PCAOB standards, then we believe that the firm should assess whether the costs of complying with the design requirement are commensurate with their perceived benefit of being registered with the PCAOB.

¹³⁸ We understand that the actual quality risks the firm faces when it takes on an engagement may differ from the hypothetical risks considered in designing the QC system. QC 1000 requires the firm to 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, and to make timely modifications as needed. *See* QC 1000.22-23.

¹³⁹ *See* Section VI.A.5.

Decision Tree for Requirements of QC System

Does the firm currently perform any of the following procedures or is it subject to the following responsibilities with respect to a PCAOB engagement?[†]



[†]An engagement performed by the firm under PCAOB standards or an engagement performed under PCAOB standards by another firm in which the firm plays a substantial role.

*APLR — Applicable professional and legal requirements.

2. Other scalability considerations

Aspects of QC 1000 are risk-based, which makes them inherently scalable. Firms are required to apply a risk-based approach to the design, implementation, and operation of the QC system in the context of their own audit practice. The standard provides that the firm will 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.

Several commenters, including firms and a firm-related group, suggested that the proposed standard was too prescriptive. Many of these commenters suggested that, to promote further scalability, specified quality responses could be replaced with quality objectives to allow each firm to develop quality responses appropriate to the circumstances and risks for their firm. One of these firms stated that it disagreed with the notion in the proposing release that a specified quality response suggests that every firm has the same or similar quality risks and that the responses to those risks will also be the same or similar. Another firm suggested that the specified quality responses make the standard inherently less scalable and could be a barrier to entry for smaller firms. The firm further suggested that an overreliance on specified quality responses could discourage firms from performing robust risk assessments and developing tailored quality responses. Other commenters also suggested that more scalability could be incorporated into the standard through consideration of concepts such as professional judgment, relevance, or reliability. Some commenters suggested that further alignment of QC 1000 to ISQM 1 or SQMS 1 would promote further scalability. One firm stated that the standard was overly prescriptive and suggested that specific guidance be provided to small and medium-sized firms focused on operability of the standard. Several commenters expressed concern that the prescriptive nature of QC 1000 would negatively affect smaller firms.

As discussed in Section III.A. above, some specified quality responses carry requirements from our current standards into QC 1000, while others provide new requirements that we believe are important to a firm's QC system. We believe that this approach is appropriate and that the specified quality responses are required to address certain quality risks that are present in all firms that perform PCAOB engagements and to assure that the QC system is designed, implemented and operated with an appropriate level of rigor. The inclusion of specified quality responses in the standard should not be interpreted to suggest that we believe all firms have the same or similar quality risks overall; the specific risks addressed by specified

quality responses are likely a small subset of the overall population of quality risks identified by a firm, and we expect potentially wide variation in the full set of risks faced by different firms.

We believe that the standard incorporates the concepts of professional judgment, relevance and reliability where it is appropriate, for example, in the ability to exercise professional judgment in the determination of whether a major QC deficiency exists, or the discussion in the information and communication component noting that information would have to be both relevant and reliable 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. We continue to believe that the inclusion of prescriptive requirements in certain areas promotes our mission of protecting investors and promoting the public interest.

An investor-related group commented that it supports a risk-based approach up to a point, but it expressed concern that the standard placed too much emphasis on scalability and recommended the development of a set of minimum requirements for the establishment of quality control systems. Another commenter stated that the PCAOB should not let scalability concerns get in the way of driving change and improving quality, further suggesting that smaller-firm considerations should not get in the way of doing the right thing for the largest audit firms. One commenter suggested more specific requirements relating to the audits of broker-dealers, commenting that a high deficiency rate in broker-dealer audits suggests the need for more specific requirements with respect to audits of broker-dealers, such as requirements for specific expertise in the conduct of broker-dealer audits, or, to the extent that the broker-dealer is a subsidiary of an issuer, requirements relating to coordination between the broker-dealer audit team and the audit team of the issuer parent company.

The final standard establishes a set of minimum requirements that all firms must follow in the establishment of their QC system. As discussed in more detail in Section IV.D. below, while QC 1000 provides some flexibility with regard to the quality risks that firms identify and the quality responses that firms develop to address those risks, it does not provide the same flexibility with regard to quality objectives or specified quality responses. Instead, quality objectives and specified quality responses that will apply to all firms are specified in the standard. Firms can establish additional quality objectives—indeed, they are required to do so if necessary to achieve the reasonable assurance objective—but they generally cannot omit or modify any of the quality objectives or specified quality responses set out in the standard.

Within a uniform basic structure to be used by all firms, QC 1000 reflects a risk-based, scalable approach, 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. We believe it is crucial that the standard be scalable so that firms of different sizes and characteristics can appropriately design their QC system to address the risks associated with

their own practice, including specific risks relating to the types of companies that they audit, such as broker-dealers. We believe that an appropriate balance between quality objectives and specified quality responses is the best approach to improve quality across firms of all sizes that perform engagements pursuant to PCAOB standards, whether these be issuer or broker-dealer engagements. Similarly, the form, content, and extent of required documentation related to the QC system will be driven by a firm's nature and circumstances. QC 1000 contains both provisions that scale down, by tailoring for smaller PCAOB audit practices, and provisions that scale up, by focusing on risks faced by the largest firms.

Some provisions of QC 1000 focus particularly on firms with a smaller PCAOB audit practice. These include:

- 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 standard; and
- If the firm issued engagement reports with respect to five or fewer engagements for issuers, brokers, and dealers during the prior calendar year, engagement monitoring activities may include monitoring audits not performed under PCAOB auditing standards. For firms with this number of engagements performed under PCAOB standards, we understand that requiring a firm to annually monitor its engagements that are performed under PCAOB standards increases the likelihood of the same partner being inspected every year under QC 1000. We believe this could disincentivize partners from serving as the engagement partner and ultimately affect competitive conditions in the market.

Other provisions of QC 1000 impose incremental requirements on firms that issued audit reports for more than 100 issuers in the prior calendar year, including:

- An external oversight function for the QC system composed of one or more persons who are not partners, shareholders, members, other principals, or employees of the firm;
- a program for collecting and addressing complaints and allegations that includes confidentiality protections;
- an automated system for identifying investments in securities that might impair independence; and
- a requirement to perform in-process monitoring of engagements.

These incremental requirements specifically target and respond to potential quality risks that we believe are more likely to arise in audit practices of a certain size and complexity. Firms

that audit fewer than 100 issuers may still determine that the incremental requirements are an appropriate quality response for quality risks that they have identified specific to their firm, but these are not mandatory for these smaller PCAOB audit practices to promote scalability of the standard.

Several commenters, including firms, suggested that the threshold for any incremental requirements be raised to 500 issuers, to align with the existing SECPS requirement that firms that audit more than 500 SEC registrants have an automated system to identify investment holdings of partners and managers that might impair independence.¹⁴⁰ One of these firms also suggested a dual-threshold approach that would consider both the number of issuers audited and the market capitalization of the issuers. Two commenters, including an investor-related group and an academic, suggested that there should not be a threshold for incremental requirements, and all requirements of the standard should apply to all firms regardless of the size of the firm. The academic suggested that the incremental requirements may give rise to actual or perceived differences in audit quality between larger audit firms that issue audit reports for more than 100 issuers and smaller audit firms that issue audit reports for fewer than 100 issuers. One firm suggested that the incremental requirements only apply to those firms subject to annual inspection under the PCAOB's rules (in case the 100-issuer threshold for regular inspection in Rule 4003, *Frequency of Inspections*, ever were changed), and another firm suggested that these should only apply to the top six firms.

Two investor-related groups suggested that if the final standard does include a threshold for certain incremental requirements, the threshold should relate to the market capitalization of the issuers that the firm's audit practice covers rather than the number of issuer audit reports the firm issues. Other commenters were also supportive of a market capitalization-based threshold.

Several commenters suggested that the nature of the firm's audit practice be taken into consideration when determining the applicability of the incremental requirements, and that just looking to the number of issuers may not be an appropriate measure for the size or complexity of the audit practice. One commenter suggested that the proportion of the PCAOB audits to the size of the practice within a firm is also a relevant factor to consider. Some commenters suggested that imposing a threshold of 100 issuers could impose a barrier to entry for firms that wish to expand their audit practices beyond 100 issuers and, as a result, firms may manage their practice to stay below the 100-issuer threshold.

We believe that requiring certain incremental requirements of firms with larger PCAOB audit practices is appropriate and that the complexities inherent to large and complex firms are likely to give rise to quality risks for which the incremental requirements would be appropriate quality responses. Based on the comments received, we considered whether alternative

¹⁴⁰ See SECPS § 1000.46 (requirement 4).

measures could be used that looked to the nature and complexity of the issuers being audited, for example, through a market capitalization-based threshold. We believe it is appropriate to retain the threshold as proposed, based on the size of a firm's issuer audit practice rather than referencing the size of the companies subject to audit by the firm.

In general, we believe that the number of issuers is the most indicative measure of a firm's size and the complexity of its audit practice. Under a market capitalization measure, a firm that audits a single very large issuer could look like a large firm, but its practice may well be less complex than a firm that audits a large number of small issuers. The incremental requirements in QC 1000 respond to specific issues or risks—firm governance, confidential handling of complaints and allegations, tracking investments that may bear on independence, and monitoring of in-process engagements—that we believe are more significant in complex practices handling large numbers of engagements. Therefore, we have adopted the threshold as proposed.

In addition, we believe that larger PCAOB audit practices that audit a greater number of issuers are more likely to have the resources to be able to effectively comply with the incremental requirements at a level commensurate to the risk.

We also believe that firms are familiar with the proposed threshold of issued audit reports for more than 100 issuers, because it is used to determine which firms are subject to annual PCAOB inspection.¹⁴¹ We do not believe it to be appropriate to increase the threshold to 500 issuers or to specifically limit the requirements to certain firms. We believe that firms that audit between 100 and 500 issuers are sufficiently large such that potential quality risks may arise as a result, and that the incremental requirements would be responsive to these risks.

Several commenters suggested that a cut-off date for the measurement of the size of the firm's issuer practice relative to the 100-issuer threshold, and a related transition period after a firm passes the 100-issuer threshold, be specified in the standard to allow time for firms to implement the incremental requirements. One of these commenters specifically requested consideration of the effective date for the implementation and operation of the incremental requirements if, because of a merger or acquisition, the resultant firm performs audits of more than 100 issuers.

The standard specifies a measurement cut-off date for the 100-issuer threshold of the prior calendar year-end. Therefore, if a firm has issued audit reports with respect to more than 100 issuers in the period January 1 to December 31, in any given year, the firm must implement the incremental requirements beginning the following January 1 and evaluate compliance with the incremental requirements as of the following September 30. We believe that firms

¹⁴¹ See Section 104(b)(1)(A) of Sarbanes-Oxley, 15 U.S.C. § 7214(b)(1)(A); PCAOB Rule 4003, *Frequency of Inspections*.

continuously track the size of their issuer audit practice for the purpose of monitoring the threshold for annual inspection by the PCAOB. Therefore, prior to the calendar year-end measurement cut-off date, we expect that firms should have an informed view as to whether they will need to design, implement, and operate the incremental requirements for the following year. Similarly, we believe that a merger or acquisition between firms would take time to finalize such that the firms would have an informed view of whether the incremental requirements would be applicable to the successor firm, providing additional time for the firms to design, implement, and begin operating the incremental requirements. In addition, we do not believe that it is appropriate or consistent with our investor protection mandate to allow a firm that audits over 100 issuers to not operate the incremental requirements beginning the calendar year following the date of the merger or acquisition if that merger or acquisition resulted in the firm auditing more than 100 issuers. We believe that specific quality risks could arise as the result of a merger or acquisition; for example, a sudden increase in the size of the firm could exacerbate the potential quality risks that exist as a result of a firm's size, to which the incremental requirements would be responsive. Furthermore, there is nothing in the standard that prevents firms from implementing the incremental requirements earlier than required, if they believe it to be likely that the threshold will be met.

IV. QC 1000: A FIRM'S SYSTEM OF QUALITY CONTROL

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

A. Introduction

.01 A quality control ("QC") system of a registered public accounting firm ("firm"), 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* and the issuance of informative, accurate, and independent *engagement* reports 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 through the preparation of informative, accurate, and independent *engagement* reports.

.02 This standard sets forth the requirements for a firm with respect to the design, implementation, and operation of a 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 and compliance with *applicable professional and legal requirements*. 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.

.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 *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 .10-.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 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 through the preparation of informative, accurate, and independent engagement reports. To emphasize the auditor's role in investor protection, we added language to the final standard reminding auditors that the firm's QC system enhances investors' ability to rely on engagement reports. We have also reversed the order of paragraphs .01 and .02 to improve flow.

One commenter suggested a risk-based approach to quality control with minimum requirements integrated into it, instead of a purely risk-based approach. We agree that a purely risk-based approach would be inappropriate. As proposed and as adopted, QC 1000 is not a purely risk-based standard. It establishes mandatory quality objectives that every firm is required to achieve; lays out detailed, required processes for risk assessment, monitoring and remediation, and annual evaluation of the QC system; requires specified quality responses in many areas; and fosters accountability and rigor through mandated key roles for the QC system with specified individual responsibility and accountability and required reporting to the PCAOB.

B. The Firm's QC System

1. QC 1000

a. Objective of the QC system

.05 A properly conducted *engagement* and the related report enhance the confidence of investors and other market participants in the company's information to which the firm's report relates. The objective of the firm is to design and, if applicable, implement and operate an effective QC system. An effective QC system protects investors by facilitating the consistent preparation and issuance of informative, accurate, and independent *engagement* reports in accordance with *applicable professional and legal requirements*. To accomplish this, an effective QC system consistently provides a firm with reasonable assurance that:

- a. The firm, each member of *firm personnel*, and each *other participant*:
 - (1) Conduct each of the firm's *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. Each *engagement* report issued by the firm is in accordance with *applicable professional and legal requirements*

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

Note: Reasonable assurance is not absolute assurance, but a high level of assurance. It 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.

The proposal asked if the reasonable assurance objective was appropriate and if there were additional objectives that the QC system should achieve. Many commenters, including firms, supported the reasonable assurance objective and did not support additional objectives for the QC system.

Some commenters, including investors and investor-related groups, said there should be an explicit acknowledgement that auditing serves a public purpose and that the system of quality control therefore should serve investors. Other investors and investor-related groups suggested that the quality control system should seek a higher performance standard than mere compliance. Two commenters suggested that the objective should be expanded, so that in addition to complying with applicable professional and legal requirements, engagements should be performed in a manner that is responsive to the needs of investors by ensuring high-quality financial reporting. Another suggested that the foundation of the system should promote high-quality and “useful” financial and non-financial information and achieve a high level of transparent financial reports. The commenter also suggested removing the qualifier “reasonable” and emphasizing that the term “assurance” refers to a high level of assurance.

We agree with these commenters that QC 1000 should frame auditor responsibilities in terms of investor protection, and we have revised paragraph .05 to reinforce that, as discussed in more detail below. We also considered broadening the objective of the QC system beyond compliance in a number of ways, as suggested by commenters.

For example, we considered adding explicit references to “investor needs” to the QC system objective. However, we are concerned that the concept of “investor needs” is too vague and indefinite to be interpreted consistently as an objective of the QC system. Consistent with the reasonable assurance objective, we believe that all investors want informative, accurate, and independent engagement reports. But beyond that, investors are not monolithic and may have different preferences. For example, the needs of a large institutional investor with an actively managed portfolio are different from those of a retail investor holding index funds. Investor needs could also vary across issuers and different types of financial instruments, as well as with changes in market conditions. As a result, we do not believe that a QC system objective that was expressly phrased in terms of satisfying “investor needs” would be capable

of consistent interpretation or would provide firms with sufficient notice or direction about the conduct required of them.

We believe that “high-quality” and “useful” financial reporting suffer from the same issues. These terms are subjective, indefinite, and would mean different things to different financial statement users and in different situations. In addition, grounding auditor obligations in the quality or utility of financial reporting risks conflating the role of the auditor with the role of the preparer. The fundamental responsibility for financial reporting lies with the company. The auditor enhances investors’ ability to rely on company financial information through the preparation and issuance of informative, accurate, and independent engagement reports, but the company prepares the financial statements and retains ultimate responsibility for them.

We considered one commenter’s suggestion of phrasing the objective in terms of “assurance,” rather than “reasonable assurance.” However, we believe that this would weaken, rather than strengthen, the standard, in that it could be read to suggest that any level of assurance, even if less than reasonable assurance, would be appropriate. As proposed, the final standard includes a note emphasizing that reasonable assurance is a high level of assurance.

Accordingly, we have not revised the objective of the QC system as these commenters suggested. We continue to believe that investor needs will be best served through an objective that is grounded in auditors’ existing obligations and can be interpreted clearly and applied consistently. Auditor obligations under applicable professional and legal requirements address investors’ fundamental priority: that the financial statements be free of material misstatement. They also clearly delineate what conduct is required, which enables both us and the firms we regulate to interpret and apply them on a consistent basis.

We have, however, made revisions to paragraph .05 that we believe will be clarifying. The final rule specifies expressly that the firm’s objective is to design, and if applicable, implement and operate an effective QC system. Further, although we concluded that we could not express the objective of the QC system in such terms, we do believe firms should be prompted to remember their critical role in investor protection. With that in mind, we revised paragraph .05 to explicitly acknowledge that a properly conducted engagement and related report enhance the confidence of investors and other market participants in the company’s information to which the firm’s report relates. We also revised the paragraph to remind auditors that an effective QC system protects investors by facilitating the consistent preparation and issuance of informative, accurate, and independent engagement reports in accordance with applicable professional and legal requirements.

Paragraph .05 specifies that an effective QC system consistently provides a firm with reasonable assurance that the firm, each member of firm personnel, and each other participant conduct each engagement and fulfill their other responsibilities in compliance with applicable professional and legal requirements, and that each engagement report issued by the firm

complies with applicable professional and legal requirements. We revised the provision to refer to “each member of” firm personnel, “each” other participant, “each” engagement, and “each” engagement report. This change clarifies that the QC system provides reasonable assurance, not just over the pool of firm personnel, the pool of other participants, and the portfolio of engagements, but over each individual and each engagement. The objective is still reasonable assurance, not absolute assurance. But an effective QC system has to be designed, implemented, and operated in such a way that the firm has reasonable assurance that each individual who performs work on behalf of the firm and each engagement the firm undertakes will comply with applicable professional and legal requirements.

One commenter asserted that some prescriptive aspects of the standard result in absolute assurance instead of reasonable assurance. We disagree, as we believe this is a misunderstanding of the standard. Specifically, the reasonable assurance objective under QC 1000 is broadly consistent 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.¹⁴² We believe that the combination of quality objectives and specified quality responses in QC 1000 establishes a balance between prescriptive requirements and a risk-based approach that contributes to the firm obtaining reasonable assurance, but does not require absolute assurance. Of course, nothing precludes a firm from going beyond the requirements in QC 1000 when designing its QC system.

One commenter suggested that the concept of reasonable assurance was not clear and could be clarified by retaining a footnote from QC 20 that reinforces that deficiencies in individual engagements do not, in and of themselves, indicate a firm’s quality control system is insufficient to provide reasonable assurance. We have not retained that footnote. The concept of reasonable assurance should be familiar to auditors; it is a basic concept under our current standards and we believe it can be interpreted and applied consistently. In addition, in light of QC 1000’s detailed process for the evaluation of the QC system, including the new defined terms “QC deficiency” and “major QC deficiency,” discussed in Sections IV.K and IV.L below, we do not believe such a footnote is necessary. Under QC 1000, firms will determine whether the QC system meets the reasonable assurance objective by determining whether any “major QC deficiencies” exist. The existence of major QC deficiencies indicates that the QC system does not provide reasonable assurance, whereas the existence of QC deficiencies that do not meet the definition of major QC deficiency does not. Since that conclusion is apparent from the definitions, we do not believe that the existing footnote is needed.

The “reasonable assurance objective” of the firm’s QC system is 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

¹⁴² See ISQM 1.14; SQMS 1.15.

of quality” (i.e., the firm’s policies and procedures),¹⁴³ whereas QC 1000’s 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 QC 1000. Firm policies and procedures are the 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 QC 1000, but they would have a different context because of the significant differences in the way in which the standard is structured.

QC 1000 is grounded in the firm’s risk assessment process, whereby the firm’s quality objectives and the risks to achieving them are identified and addressed by the firm in an ongoing, structured fashion. This risk assessment process drives how the firm develops and refines its policies and procedures; the “quality responses” are designed and implemented to address quality risks. As such, policies and procedures are a means to an end—addressing quality risks—rather than an end in themselves. QC 1000 provides 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 does not mean that firms’ QC policies and procedures are no longer important. On the contrary, they are critical to addressing quality risks and thereby 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 is based on whether the firm has met its quality objectives and the reasonable assurance objective—which are driven by whether the firm’s policies and procedures have in fact been effective in addressing quality risks—and on whether the firm has complied with the requirements of the standard in the design, implementation, and operation of the QC system. Another commenter suggested that the QC system should not address firm policies and procedures that go beyond applicable professional and legal requirements, on the basis that it might undermine investor protection by disincentivizing firms from developing policies and procedures that go beyond what is required. For the reasons discussed above, we have not included policies and procedures in the reasonable assurance objective. However, because policies and procedures play an important role in the firm achieving the reasonable assurance objective, we have determined that some quality objectives have to incorporate compliance with firm policies and procedures as well as applicable professional and legal requirements.

The reasonable assurance objective also reflects the view that the purpose of the QC system is to drive overall compliance by the firm, each member of firm personnel, and each other participant with applicable professional and legal requirements, and not necessarily to drive more narrow compliance with firm policies and procedures.

¹⁴³ QC 20.03; QC 20.17.

Under QC 1000, the reasonable assurance objective of the firm's QC system is generally consistent with the objective of the QC system under our existing QC standards but, in addition to the changes discussed above, it places more emphasis in three key areas:

- Expressly reminding auditors that an effective QC system protects investors by facilitating the consistent preparation and issuance of informative, accurate, and independent engagement reports;
- 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 and PCAOB rules, other provisions of U.S. federal securities law, and other applicable legal and regulatory requirements); and
- Expressly mentioning compliant engagement reporting (an existing responsibility under PCAOB standards), given the explicit reference to audit reports in Sarbanes-Oxley.¹⁴⁴

Responsibilities in this context include 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 objective covers the activities of a broader group than current standards. It applies 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 QC 1000 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. Many commenters, generally firms and related groups, expressed concern about the inclusion of other participants in the reasonable assurance objective. We believe that the firm's own QC system must address all the work done on the firm's engagements and in connection with the design, implementation, and operation of the firm's QC system, regardless of who does it. The reasonable assurance objective in QC 1000 appropriately reflects that scope.

¹⁴⁴ 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).

b. Requirements to Design, Implement, and Operate a QC System

.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 .10-.17);
- b. Establish *quality objectives*, annually identify and assess *quality risks* to the achievement of those objectives, and design *quality responses* to address 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*, and thereafter through the following September 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 September 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.

QC 1000 requires all firms to design a QC system that complies with the standard. This entails assigning QC-related roles and responsibilities as provided in paragraphs .10-.17; establishing quality objectives, at least annually identifying and assessing quality risks to the achievement of those objectives, and designing quality responses to address 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 is based on the quality risks the firm likely would face if it performed engagements.

We received a significant volume of comments on this aspect of the proposal, which we discuss in Section III.C.1 above. In addition, one commenter suggested emphasizing the concept of professional judgment by incorporating it in paragraph .06 or .07 and defining it in Appendix A of QC 1000. It is true that under QC 1000, judgment may have to be exercised in areas of the QC system, such as assessing risk and evaluating QC deficiencies. However, the basic approach of QC 1000, which specifies quality objectives to be achieved through specified risk assessment and monitoring and remediation processes, is outcome-based and not simply a matter of professional judgment. Moreover, under paragraph .10, all activities related to the QC system must be performed with due professional care. This means that even in judgmental areas, professional judgment is not unbounded; individuals must exercise professional skepticism and use the requisite knowledge, skill, and ability to diligently (and in good faith and with integrity) obtain and objectively evaluate information. Accordingly, we are adopting these requirements as proposed.

In addition to the obligation to design the QC system, firms are required under paragraph .07 to implement and operate an effective QC system (i.e., comply with all provisions of the 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.¹⁴⁵ This would occur, 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 or continue after issuance of the engagement report, such as retention of audit documentation, issuance of reports included in Securities Act filings (including consent to the inclusion of such reports),¹⁴⁶ other engagement deficiencies,¹⁴⁷ and subsequently discovered facts.¹⁴⁸ Once a firm no longer has any responsibilities under applicable professional and legal requirements with respect to any firm

¹⁴⁵ 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.

¹⁴⁶ See AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*.

¹⁴⁷ See AS 2901. We are amending AS 2901 in connection with this rulemaking to expand auditor responsibilities with respect to engagement deficiencies. See Section V.A for additional discussion.

¹⁴⁸ See AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

engagements, the firm will be required to continue operating the QC system until the next September 30 (the next date as of which the firm is required to evaluate the QC system). This ensures that the firm will evaluate and report on the QC system for any year during which the QC system was required to operate.¹⁴⁹

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 company previously audited by the firm. Under the standard, registered firms will have to stand ready to have their QC system implemented and operating over such responsibilities whenever they arise.

Although all PCAOB-registered firms are required to design a QC system that complies with the standard, the obligation to implement and operate that system applies only when the firm is 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 relevant 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 is driven by the professional and legal requirements that apply to the firm and its engagements and the relevant risks, which may vary depending on the nature and extent of the firm's practice.

The 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, are not extinguished when a firm transitions from full applicability to scaled applicability.

As discussed in more detail in Section III.C above, our view is that requiring all registered firms to design a QC system that complies with QC 1000 is 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 paragraph .06, is justified in cases where a firm is not subject to any obligations under applicable professional and legal standards with respect to any firm engagement.

¹⁴⁹ The requirements for evaluating and reporting on the QC system are discussed in Section IV.L below.

c. 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 unregistered accounting firms.

We did not receive comments specifically on these paragraphs and are adopting them as proposed. These paragraphs require 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.

Under the standard, the firm is required to design, implement, and operate a QC system that reflects and responds to the firm's particular risks through two process components.

- 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 address the identified quality risks—is applied to all of the aspects of the firm’s organization and operations that are covered by the QC system and thus is tailored to each firm’s specific facts and circumstances.
- The monitoring and remediation process is carried out in a way that is informed by and responsive to risks—for example, quality risks influence both the selection of engagements to monitor and the design and extent of monitoring activities.

The requirement to evaluate the effectiveness of the QC system supports 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 aspects of QC 1000 that are risk-based are inherently scalable. In applying a risk-based approach, the firm is 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 will likely be required to have a more complex QC system than a small firm that performs a small number of less complex engagements.

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.¹⁵⁰ The QC system encompasses the firm’s organizational structure, policies adopted, and procedures established to provide that reasonable assurance.¹⁵¹ Registered firms are required to design, implement, and operate a system of quality control to provide this reasonable assurance.

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

¹⁵⁰ See QC 20.03.

¹⁵¹ See QC 20.04.

aspect of the QC system creates clearer lines of communication and decision-making authority and greater accountability for those assigned to such roles. One commenter on the overall requirements supported them as proposed. Some firm commenters also supported the proposed roles and offered operational suggestions, while other firm commenters asserted that the proposed roles and responsibilities were not clear and appropriate for the reasons described in the following subsections.

1. QC 1000

a. 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 in all matters related to the QC system. Due professional care concerns what those individuals do and how well they do it. Due professional care means acting with reasonable care and diligence, exercising professional skepticism, acting with integrity, and complying with *applicable professional and legal requirements*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the relevant information.

Paragraph .10 of the standard addresses due professional care in performing responsibilities in relation to the QC system. Due professional care, applicable to all firm personnel and other participants, includes professional skepticism. 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, QC 1000. We believe that this provision is a helpful clarification because the PCAOB standards describing due professional care do not specifically mention QC activities.¹⁵²

One commenter urged us to clarify the need for professional skepticism by leadership in quality control roles. We do not believe specific provisions are needed in that regard, because paragraph .10 applies to all individuals performing QC roles, including those in leadership roles.

We are adopting this provision with modifications to align with the descriptions of due professional care and professional skepticism being adopted in AS 1000.¹⁵³

¹⁵² A new auditing standard, AS 1000, is being adopted to combine and update the four standards that set forth the general principles and responsibilities of the auditor, including AS 1015, *Due Professional Care in the Performance of Work*. See Auditor Responsibilities Release.

¹⁵³ *Id.*

b. Assignment of 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 needed 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: Each of the roles identified in subparagraphs a.-c. above cannot be shared, but rather must be assigned to only one individual. However, 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 .12) to the individual assigned ultimate responsibility and accountability for the QC system as a whole (*see* paragraph .11).

We proposed 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 did not prescribe the substantive qualifications the highest-ranking executive in the firm should have; the proposal did 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 was to establish accountability for QC

at the highest level within the firm and underscore the critical importance of the QC system. One commenter supported this requirement, as it is analogous to the CEO being jointly responsibly for the SEC certifications with respect to the financial statements and internal controls. One commenter requested clarification on the structure of smaller firms where the firm's CEO may not be an audit practitioner and may rely on others to fulfill the requirements of the QC system. We believe it is important for the firm's principal executive officer, irrespective of whether that person is an audit practitioner, to be ultimately responsible and accountable for the firm's QC system, because we believe that this will lead to more vigorous oversight of the audit practice; benefiting investors and other stakeholders that rely on the firm's work.

The requirement in paragraph .12 of QC 1000 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; 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.

A number of commenters suggested that the roles in paragraph .12 should be able to be split into multiple roles or assigned to multiple people. Commenters asserted that the roles, such as operational responsibility for the ethics and independence component, are complex enough to require two individuals. Several of the same commenters expressed that the requirement is generally too prescriptive. Several firms indicated that many firms in larger networks may commonly have these specified roles filled by individuals outside of the firm and the restriction of these roles to firm personnel may be problematic operationally.

For the roles specified in paragraph .12, the final standard retains the requirement that 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 will remain with the one assigned individual. For example, a firm could assign one person to ethics-related matters and another person to independence-related matters, as long as both of these individuals report to the person with operational responsibility for the firm's compliance with ethics and independence requirements. We acknowledge that some firms may seek assistance from their network or other participants in performing some of their QC-related activities, but we believe a single individual within the firm should remain responsible for the operational responsibilities of the assigned roles. 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.

Commenters generally supported allowing one person to hold multiple responsibilities under certain circumstances, such as smaller firms with limited resources. Two commenters

supported the roles as proposed and one commenter suggested the firm's head of audit practice also be included as a role.

Our view is that the roles specified in paragraph .12 would be appropriate for every firm. Provided that the criteria in paragraph .12 of 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. We have not been specific about who should be assigned the roles identified in paragraph .12. A firm may determine, based on its nature and circumstances, that it is appropriate to assign already established leaders to one or more of these roles, such as the head of audit practice as suggested by a commenter.

One commenter requested clarification of the intended role in .12d. The role in paragraph .12d allows firms to assign operational responsibility for other components (e.g., the resources component) based on the nature and circumstances of the firm. The standard provides 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.

The proposal asked if firms would have difficulty filling the assigned roles. Two commenters were optimistic these roles could be filled in light of the requirements. Commenters cited increased liability or workload associated with these roles as potential disincentives that may keep qualified individuals from accepting these roles. Specifically, some commenters asserted that the proposal would lower the threshold for individual liability compared to current requirements, and that the threat of enforcement sanctions would deter individuals from accepting the roles.¹⁵⁴ One commenter sought clarification on the supervision obligations prescribed under QC 1000 and the Board's authority to bring enforcement actions for failure to reasonably supervise under Section 105(c)(6) of Sarbanes-Oxley. One commenter recommended amending paragraph .11 to acknowledge that individuals assigned ultimate responsibility for the QC system as a whole can rely on information provided to them and their responsibility is governed by a good faith standard. Two commenters expressed concern that firms, especially smaller issuer or broker-dealer practices, would have difficulty filling the specified roles. One commenter was concerned with increased accountability and suggested balancing accountabilities such that processes and outcomes, as well as rewards and penalties, are more appropriately weighted.

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

¹⁵⁴ Analogous concerns were also raised by commenters in relation to the separate rulemaking *Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability*, available on the Board's website in Docket 053.

can be brought against individuals for contributing to violations by the firm¹⁵⁵ or for failing to reasonably supervise an associated person of the firm who commits certain violations.¹⁵⁶

Under 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 enumerated responsibilities, as well as for contributing to firm violations or failing reasonably to supervise.¹⁵⁷ As discussed further in the sections that follow, the individuals who fill the roles specified in paragraphs .11 and .12 of QC 1000 have specified responsibilities spelled out in paragraphs .14 through .17 of the final standard. Those individuals must exercise due professional care (see paragraph .10), and their failure to properly discharge their duties—for example, to establish or direct the establishment of certain QC-system reporting lines (see paragraph .14b), to certify the firm’s Form QC report to the PCAOB (see paragraphs .14d and .15b), or to timely communicate certain information to others (see paragraphs .16b and .17b)—would constitute violations of QC 1000. So while current QC standards generally require either a primary violation by the firm to trigger an individual’s potential liability under Rule 3502 or a primary violation by another associated person to trigger a supervisory person’s potential liability under Section 105(c)(6) of Sarbanes-Oxley, QC 1000 creates a framework in which an individual’s failure to discharge prescribed responsibilities could give rise to individual liability without regard to whether primary violations were committed by another.

That is not to say, however, that the individuals filling the roles specified in paragraphs .11 and .12 of QC 1000 no longer can be charged with contributing to violations by the firm or for failing to reasonably supervise an associated person who commits certain violations. Because of the important role played by the individuals filling those roles, their failure to properly fulfill their responsibilities may contribute to violations by their firm. Furthermore, paragraphs .15a, .16a, and .17a of the final standard make clear that the individuals who fill the roles discussed therein are supervisory persons who have supervisory responsibilities under our QC standards, for purposes of Section 105(c)(6) of Sarbanes-Oxley.

We believe that providing another basis for enforcement against responsible individuals could enhance their accountability for the QC system. Enhanced accountability emphasizes the importance of the firm assigning roles to firm personnel who have the experience, competence, authority, and time needed to carry out their assigned responsibilities. Although we recognize that some commenters expressed concern about whether individuals would be willing to

¹⁵⁵ See PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*. The Board has proposed to amend Rule 3502 in certain ways, including by changing the standard of conduct for associated persons’ contributory liability from recklessness to negligence. See *Proposed Amendments to Rule 3502 Governing Contributory Liability*, PCAOB Rel. No. 2023-007 (Sept. 19, 2023).

¹⁵⁶ See Sarbanes-Oxley § 105(c)(6), 15 U.S.C. § 7215(c)(6).

¹⁵⁷ See PCAOB Rel. No. 2023-007.

assume these specified roles, we believe that these roles are necessary and appropriate for every firm. We also believe that, with appropriate incentives, firms should be able to fill these roles. We are adopting these requirements as proposed.

We discuss each of the QC roles identified in the 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. One commenter supported a feedback loop between the individuals assigned responsibilities under paragraphs .11 and .12, but sought clarity regarding whether individuals in the roles in paragraph .12 are required to report to the firm's principal executive officer. We are not prescribing the firm's reporting structure related to those roles, as it may vary based on the nature and circumstances of the firm.

c. 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 standard emphasizes 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.

The individual assigned ultimate responsibility and accountability is 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 will be dependent on the firm's nature and circumstances. For example, in a smaller firm where there are fewer individuals with assigned roles, structures 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 is 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 may 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 proposed 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. One commenter expressed concern that the certification requirements may create a barrier to firms operating in environments that do not have Sarbanes-Oxley-style reporting requirements. The same commenter also emphasized the certifications may have a disproportional impact on smaller firms that have fewer resources. One commenter suggested that certification by the firm's CEO is an ineffective incentive and a more appropriate incentive would be compensation that was heavily weighted towards effective QC systems.

As we discuss further in Section IV.L.1.c.iii below, we believe such certification will lead to increased discipline in the evaluation process and reinforce the accountability of the certifying individuals, and have adopted that requirement as proposed. We believe certifications are commonly known among issuers within our regulatory environment and would be familiar to their auditors. We also believe the certification requirements will complement the revised provisions in paragraphs .25b and .44g of the final standard, which address compensation incentives based on an effective QC system.

d. 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*).

This requirement did not draw comment and we are adopting it as proposed.

The individual assigned operational responsibility and accountability for the QC system as a whole is accountable for supervising the design, implementation, and operation of the firm's QC system. This includes 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 may 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 includes 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 requiring 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.¹⁵⁸

e. 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 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. Like in the proposal, in the final standard the individual assigned operational responsibility for compliance with ethics and independence requirements will supervise the areas addressed by the ethics and independence component of QC 1000, 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, 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 is then responsible for communicating such violations to the individuals assigned

¹⁵⁸ 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.

operational responsibility for the monitoring and remediation process and operational responsibility and accountability for the QC system as a whole.

Paragraph .16b, as well as several other requirements in the standard, refers 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 communication and 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, communication and action may have to be immediate to be timely. The only commenter on this term agreed that what constitutes “timely” would depend on the underlying matter to which action relates. The commenter also wanted clarification that the firm’s policies and procedures assist in promoting communication such that the appropriate individuals with responsibilities over the firm’s QC system become aware of relevant matters in a timely manner, as appropriate for the size and the scale of the firm and relative nature of the matter. Insofar as the comment may be read to suggest that the size and scale of the firm, on its own, is a factor in determining timeliness, we disagree. In our view, timeliness is a function of the nature and significance of the issue (appreciating that the size and scale of the firm may be relevant in gauging the nature and significance of an issue).

One commenter expressed concern that the prescriptiveness of the communication requirements may detract from the achievement of the intended objectives. Specifically, the commenter was concerned that it may not be appropriate to require communication of all violations to the individual with operational responsibility and accountability for the QC system as a whole.

The specified communications are intended to enable these individuals to take timely and appropriate actions in accordance with their responsibilities. In our view, in order to do that, they need to be apprised of ethics and independence violations. Ethics or independence violations may take a variety of forms, and therefore the nature and extent of the communication may also take a variety of forms commensurate to the severity and pervasiveness of the violation. Leaving aside the question of whether a violation of ethics or independence requirements could ever be insignificant, individual violations may evidence problems within specific areas of the firm’s policies and procedures or an overall pattern of disregard for ethics and independence requirements that requires timely intervention. We have adopted these requirements as proposed.

f. 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 a 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, results in an approach that drives continuous improvement, and provides the firm with information about whether the QC system is operating effectively. As proposed, 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.

One commenter was concerned that it would be a conflict of interest for this individual to oversee both the monitoring and remediation process and the evaluation process. Another commenter recommended that the responsibility for the annual evaluation be shared between the individual with operational responsibility for the QC system as a whole, who recommends the evaluation conclusion, and the individual with operational responsibility for the monitoring and remediation process, who concurs or recommends changes to the conclusion. We understand that in a smaller firm these roles may all be performed by the same individual. In a larger firm that assigns different individuals to the roles, the individual with operational responsibility for the monitoring and remediation process supervises the evaluation process. Although the individual overseeing the monitoring and remediation process also oversees the evaluation process, other aspects of QC 1000 drive accountability for the evaluation. Paragraph .14c makes the individual assigned ultimate responsibility and accountability for the QC system as a whole accountable for the annual evaluation. Additionally, paragraphs .14d and .15b impose certification requirements that also drive accountability for the evaluation process. We have adopted this requirement as proposed.

The individual assigned operational responsibility for the monitoring and remediation process is also 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 facilitates and supports 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.

QC 1000 retains and expands on these concepts. However, rather than specifying that a senior-level partner be responsible for independence matters, the standard takes a more

functional approach, requiring a person with the experience, competence, authority, and time needed to enable that person to carry out the assigned responsibilities.

Another key difference, as discussed above in Section IV.C.1, is that QC 1000 imposes specific responsibilities on the individuals assigned the specific roles, such that enforcement action could be brought against them individually if they fail to meet those responsibilities.

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, creates a feedback loop to drive continuous improvement of the firm's QC system.

The proposal included a risk assessment process that would be principles-based and could be tailored to the size and complexity of the firm and the types and variety of engagements it performs. Several commenters, including firms, were generally supportive of a risk-based approach to the firm's QC system. One commenter, an investor-related group, expressed concern that a principles-based approach would allow audit firms too much discretion in conducting their own risk assessment. Another commenter noted that while they generally supported a risk-based, scalable approach, they supported a more prescriptive approach for the resources and monitoring and remediation components.

We have retained the approach as proposed because we believe that applying a risk-based approach to the design, implementation, and operation of the QC system will prompt firms to identify and focus on the most relevant risks to quality in the context of their own practice and will make QC 1000 appropriately adaptable to future changes in technology, regulation, and the business environment. It will also ensure scalability, allowing firms to right-size their QC systems as their practices grow and change. As discussed above, QC 1000 contains a balance of prescriptive and risk-based elements.

One commenter requested clarity on whether QC 1000 would operate separately or in concert with other quality control standards, specifically whether the risk assessment process would apply only to engagements performed under PCAOB standards or to the firm's overall risk assessment of all its engagements, including those performed under other standards. Consistent with the way the term "engagement" is defined in QC 1000,¹⁵⁹ the requirements of QC 1000, including those regarding the firm's risk assessment process, generally apply only to work performed under PCAOB standards. However, nothing prevents a firm from designing, implementing, and operating a single risk assessment process for its entire audit and assurance

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See Section III.B.2.

practice that satisfies both QC 1000 and the other quality control standards that apply to the firm.

The 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.¹⁶⁰ The standard creates 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,¹⁶¹ the firm is required by QC 1000 to monitor, identify, assess, and respond to changes in relevant conditions, events, and activities that affect the firm's QC system.

1. 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 address the *quality risks*.

The firm's risk assessment process applies to the six components of the firm's QC system that specify quality objectives. To design, implement, and operate this process, the firm is required to:

- Establish quality objectives;
- Identify and assess quality risks to the achievement of the quality objectives; and
- Design and implement quality responses to address 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 standard would not necessarily be addressed in a 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

¹⁶⁰ See generally AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

¹⁶¹ See AS 2110.74.

quality risks. The risk assessment process is also iterative and ongoing, so that new or developing risks are identified and addressed as they emerge. 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. We believe that the risk assessment approach will 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.

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 *engagements* (see paragraph .38), *engagement* performance (see paragraph .42), resources (see paragraph .44), and information and communication (see paragraph .53).

The standard defines quality objectives as the desired outcomes in relation to the components of the QC system to be achieved by the firm. 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.

One investor-related group expressed concern with the lack of specificity in the proposed standard regarding the design of an audit firm's quality control system, suggesting that the proposed standard would enable firms to design a QC system that could too easily be certified as working properly. We believe that the quality objectives specified in QC 1000 will promote an appropriate level of rigor in the QC system. While QC 1000 provides some flexibility with regard to the quality risks that firms identify and the quality responses that firms develop to address those risks, it does not provide the same flexibility with regard to quality objectives. Instead, quality objectives that will apply to all firms are specified in the standard. Firms can establish additional quality objectives—indeed, they are required to do so if necessary to achieve the reasonable assurance objective—but they generally cannot omit or modify any of the quality objectives set out in the standard. Therefore, firms do not determine the criteria by which their QC systems will be assessed, only the means by which they will meet those criteria.

Quality objectives are specified in the standard for six of the components of the QC system: governance and leadership, ethics and independence, acceptance and continuance of engagements, engagement performance, resources, and information and communication. A firm may 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 standard, it would nevertheless be carried out in a way that is informed by and responsive to quality risks.¹⁶²

We believe that, for many firms, the quality objectives specified in the standard are likely to 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 is 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:

The proposal defined 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 definition of quality risks is aligned with use of the term in PCAOB

¹⁶² 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.

standards:¹⁶³ 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*.¹⁶⁴

A number of commenters raised questions or made suggestions about the proposed treatment of intentional acts in the definition of quality risks. One commenter suggested that intentional misconduct should not be explicitly addressed in the definition because the necessary response, especially as it relates to colleagues’ behavior, may negatively impact the trust among colleagues and could constrain the achievement of quality objectives. Instead, this commenter suggested that the risk of intentional misconduct may be more effectively considered and responded to as part of the broader understanding of quality risks. Another firm expressed concern that requiring consideration of all illegal acts would contradict a risk-based approach.

Several firms agreed that the definition of quality risks should explicitly address the risk of intentional misconduct but suggested that the definition should also address the possibility of occurrence related to acts of intentional misconduct. Several commenters, including firms, firm-related groups, and an academic, recommended that the threshold of “reasonable possibility of occurring” should apply to all quality risks, including risks of intentional misconduct. Many of these commenters said that not applying the threshold of “reasonable possibility of occurring” to the risk of intentional misconduct would not be practical and could harm audit quality as this would divert time, resources, and attention from addressing more reasonably possible risks. Some commenters referenced the inclusion of the “reasonable possibility of occurring” threshold in AS 2110, and suggested that the same principle should apply to the risk of intentional misconduct in QC 1000. Two of these commenters suggested that not applying the threshold of “reasonable possibility of occurring” to the definition of quality risks would be inconsistent with AS 2401, *Consideration of Fraud in a Financial Statement Audit*, and could impose a threshold on firms that exceeds the current auditing standards over auditors’ identification and assessment of fraud risks. Several commenters also stated that the inclusion of other participants in addressing every conceivable risk of intentional misconduct may be impractical as firms may have limited access to information on the conduct of other participants. One firm suggested that additional guidance may be beneficial with regard to assessing and responding to risks of intentional misconduct by other participants that are not part of the firm.

A firm-related group suggested that not applying the threshold of “reasonable possibility of occurring” to intentional misconduct appeared to go beyond the reasonable

¹⁶³ See generally, e.g., AS 1105, *Audit Evidence*; AS 2101; AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

¹⁶⁴ See FASB ASC paragraph 450-20-25-1; see also, e.g., footnote 4 to AS 1105.12, which incorporates the ASC definition.

assurance objective and expressed concern that, without further clarification of how firms should deal with risks of intentional misconduct with less than a reasonable possibility of occurring, a disproportionate level of resources could be allocated to this area, to the detriment of other quality risks with more than a remote possibility of occurring.

After considering the comments received, we are revising the definition of quality risks such that the threshold of “reasonable possibility of occurring” applies to all risks, including risks of intentional misconduct by firm personnel and other participants. However, we continue to believe that firms should be explicitly prompted to consider risks of intentional misconduct in their risk assessment process, because without such a 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, the final definition provides that, for all risks, whether or not related to intentional misconduct, the firm would assess the possibility of occurrence and the possibility that the risks would have an adverse effect on the achievement of its quality objectives.

One firm suggested that while the threshold of “adversely affecting” is reasonably understood, additional guidance or examples would be welcomed. Another commenter noted that more examples serve as helpful interpretive guidance to those implementing the standard. Two firms believed the threshold is sufficiently clear and did not have specific requests for further guidance. We will monitor the implementation of the new standard by audit firms, and, if appropriate, consider the need for additional guidance.

The standard requires 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. The nature and extent of the firm’s risk assessment process would be commensurate with the firm’s quality risks and therefore will vary across firms in nature, scope, and complexity. 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.

One commenter requested clarification of whether the Board expects firms to categorize the identified risks (for example as lower, higher, or significant). While there is nothing in QC 1000 that requires such categorization, firms that find such an approach helpful could certainly use it.

The standard requires the identification and assessment of quality risks annually. Requiring an assessment annually, as well as when matters come to the firm’s attention, drives 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 process of risk assessment. This reactive approach can result in firms taking corrective actions only after deficient audits have been identified. The annual identification and assessment requirement will instill a regular and disciplined approach to performing the risk assessment process 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 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)-(j) 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 standard requires 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 underpins 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 standard provides examples related to the nature and circumstances of the firm and its engagements that may give rise to quality risks.

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.

Several commenters, including firms, noted that the examples provided in Appendix B were helpful. Two commenters expressed concern with the language used in paragraph .20a., specifically, that it was not sufficiently clear that the specific examples in Appendix B are meant to be illustrative rather than a checklist for every firm to consider. As we stated in connection with the proposal, 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, depends 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 to any of the specific examples.

One firm expressed concern with the inclusion of proposed paragraph .B10b. in Appendix B, which discusses the extent of alignment of a third-party provider's standards of conduct with those of the firm. The firm suggested that the example may imply that third-party providers from outside the public accounting profession may not be appropriate or sufficient, because they may not be subject to a centrally governed code of conduct. Nothing in our standards requires a third-party provider to have a centrally governed code of conduct and we have added the phrase "if any" to the example to eliminate any ambiguity in that regard. However, we do believe that the existence of such a code of conduct, and the extent to which it aligns with the firm's own standards of conduct, is a relevant example that could be considered by a firm in assessing whether there exist conditions, events, or activities, as a result of its use of resources or services obtained from third-party providers, that may adversely affect the achievement of its quality objectives.

1) *The nature and circumstances of the firm*

The 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 standard, which also provides specific examples of each consideration in paragraphs .B2 through .B11.

We continue to believe that to consistently execute quality audits, it is important that a commitment to audit quality is embedded in the firm's culture and exists throughout the firm. In connection with this, we have added a new paragraph .20a.(1)(d) and Appendix .B5 to provide firms with an additional risk assessment consideration relating to the culture of the firm, and the extent to which a culture of integrity and a commitment to audit quality, including ethics and independence, is promoted within the firm and embraced by firm personnel across all levels of the firm.

In addition, we have added to paragraph .B6e. to highlight that in understanding the resources of the firm, the firm may also have to consider the risks associated with technological resources, including their susceptibility to cybersecurity breaches.

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

(d) The extent to which a culture of integrity and a commitment to audit quality, including ethics and independence, is promoted within the firm and embraced by *firm personnel* across all levels;

This includes how a commitment to quality is embedded in the firm's culture and exists throughout the firm.

(e) The resources of the firm;

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

- (f) 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.

- (g) 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.

- (h) 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.

- (i) 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.

- (j) 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 considers the types of engagements performed by the firm as well as the types of entities for which such engagements are undertaken. Paragraph .B12 of Appendix B of the standard contains a list of examples of these considerations. For instance, a firm that conducts audits of broker-dealers may consider information from relevant authorities, like the

SEC and Financial Industry Regulatory Authority (“FINRA”), in identifying risks associated with such audit engagements. We have added an example to paragraph .B12a. to highlight that in understanding the nature and circumstances of the firm’s engagements, the firm may also consider the laws and regulations to which the companies it audits are subject.

3) Other relevant information

Other relevant information captures other information sources that help the firm to identify quality risks. One such source is the firm’s monitoring and remediation activities. Consideration of information from those activities creates 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.

Other sources are 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 within a specific office of the firm or within a certain employee staff level, 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 standard, identifying and assessing quality risks is an ongoing, iterative process. The firm assesses 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 standard requires 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 clarifies 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.¹⁶⁵ One commenter agreed with the clarification provided in the note that the assessment is based on inherent risk, but expressed concern that the note may not be sufficient to prompt or remind auditors of the independence of quality risks from quality responses. We believe that the note to paragraph .20b. provides clear direction for assessing quality risks without regard to the effect of quality responses. We will monitor the implementation of the new QC standard, and, if appropriate, consider the need for additional guidance. 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 or engagement acceptance and continuance.

Under the definition of quality risks, the firm would not be required to identify every conceivable risk, but only those that have a reasonable possibility of occurring and, if they were to occur, a reasonable possibility of adversely affecting the firm's achievement of one or more quality objectives. 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.

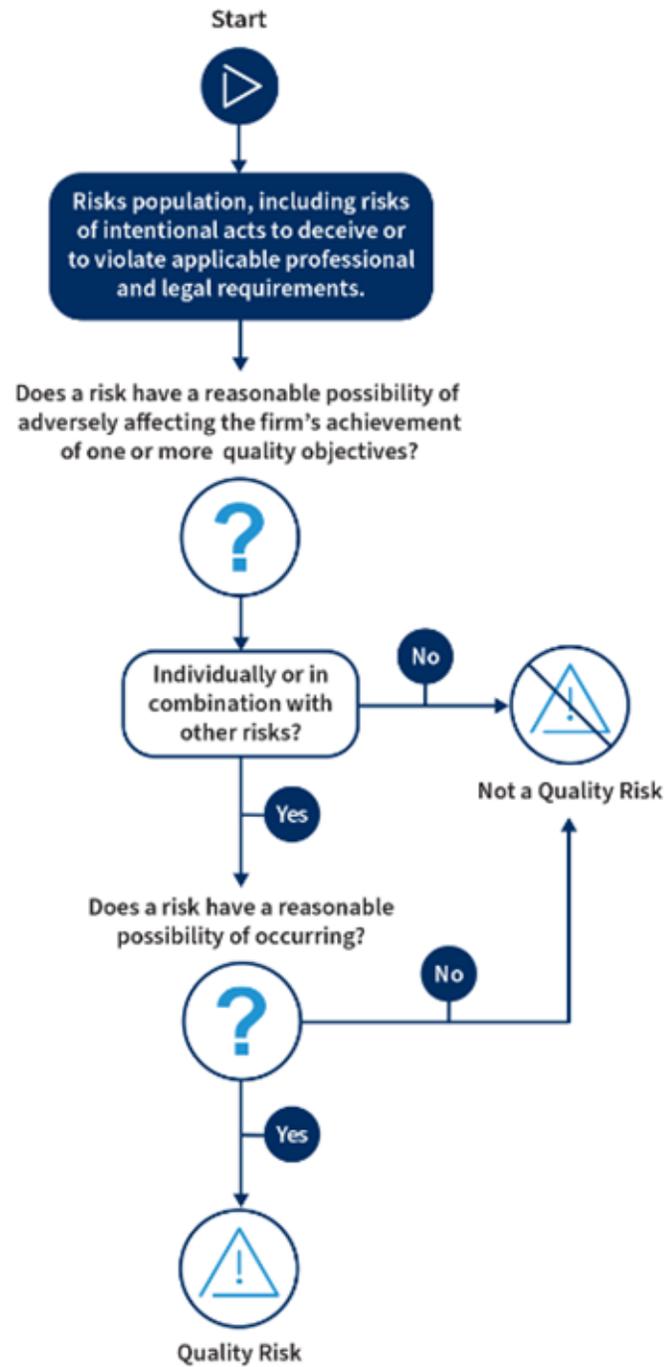
The firm may undertake the quality risk assessment separately or concurrently with risk identification. Assessing the identified quality risks involves consideration of the frequency with which the quality risks may occur and the magnitude of the impact of the quality risks on the related quality objective(s). 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 actual quality risk.

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

¹⁶⁵

See AS 2201.A10.

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 standard requires 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 definition, policies are statements of what should, or should not, be done to address assessed quality risks. Procedures are actions to implement and comply with policies.

Under the principles-based approach of the standard, the nature, timing, and extent of quality responses depend on the underlying quality risks and the reasons why these risks were assessed as quality risks. For example, a quality risk that is tied to an event that is expected to occur multiple times per year, or that could have a very significant impact, requires 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.

Quality responses may vary depending on to whom they apply. For example, based on the quality risks that are being addressed, the firm may develop some policies and procedures that are applicable to all firm personnel and others that apply only to firm leadership or personnel in a particular function or geographic location. Similarly, the firm's policies and procedures regarding other participants may be different for different types of other participants (e.g., network affiliates, engaged specialists).

Information obtained from the identification and assessment of quality risks enables 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 by the firm, the standard requires certain specified quality responses for all firms. Some specified quality responses are drawn from existing PCAOB requirements¹⁶⁶ or from the specified responses in ISQM 1,¹⁶⁷ 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. Other specified quality responses are new provisions that we believe are sufficiently important to merit an explicit requirement. The specified quality responses are not intended to be comprehensive; on the contrary, for most of the components of the firm's QC system, QC 1000 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 must 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 are critical in addressing quality risks.

For example, the specified quality response requiring mandatory training¹⁶⁸ may address some of the quality risks related to certain quality objectives in the resources component (e.g., hiring, developing, and retaining firm personnel).¹⁶⁹ However, mandatory training alone will not be sufficient to address all the quality risks that may be identified for that quality objective and will 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

¹⁶⁶ See, e.g., QC 20.10, .13a, .13b, and .15a.

¹⁶⁷ See paragraph .34 of ISQM 1.

¹⁶⁸ See QC 1000.48.

¹⁶⁹ See QC 1000.44a.

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.

The standard requires 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 responses that are affected by this event, and thus avoid potential problems in future engagements.

One commenter suggested that it may be cost beneficial to require or encourage audit firms' QC leaders to stay current with developments in auditing literature to put them in a better position to triage newly identified quality risks and identify engagements susceptible to those risks. Another commenter recommended that firms be required to create an individual or other entity charged with maintaining situational awareness.

We note that paragraph .22 of QC 1000 requires firms to establish policies and procedures for monitoring changes to conditions, events, and activities that indicate modifications to the firm's quality objectives, quality risks, or quality responses may be needed. In addition, the individual(s) responsible for monitoring such changes are subject to the general due professional care standard of QC 1000.10, which requires a critical assessment of the relevant information (which would include relevant literature). In light of these overarching requirements, we do not consider it necessary to add the specific provisions that commenters suggested. Rather, we believe that allowing flexibility for firms to establish policies and procedures to monitor, identify, and assess changes to conditions, events, and activities encourages firms to concentrate their efforts on the risks most relevant to them and contributes to the standard being appropriately scalable. A firm may of course determine, based on its nature and circumstances, that it is appropriate to establish specific policies and procedures for the monitoring of developments in auditing literature or to charge a specific individual with maintaining situational awareness.

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 standard requires the firm to determine what, if any, modifications are needed, and to make them on a timely basis. The timing depends 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 so 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.¹⁷⁰

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

¹⁷⁰ 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).

for reviewing firms' QC systems.¹⁷¹ 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.¹⁷²

1. QC 1000

.24 This 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.

a. Governance and leadership quality objectives

Under QC 1000, a firm is 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 investors and the public interest by consistently fulfilling its responsibilities under *applicable professional and legal requirements*;

¹⁷¹ See, e.g., Report on the PCAOB's 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms, PCAOB Rel. No. 2008-008 (Dec. 5, 2008) at 6, available at https://pcaobus.org/Inspections/Documents/2008_12-05_Release_2008-008.pdf; *Staff Inspection Brief, Vol. 2017/3: Information about 2017 Inspections* (Aug. 2017) at 8, available at <https://pcaobus.org/Inspections/Documents/inspection-brief-2017-3-issuer-scope.pdf>.

¹⁷² See <https://pcaobus.org/oversight/inspections/inspection-procedures> for information related to the PCAOB's inspection procedures.

- (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, including through their performance evaluation and compensation.
 - 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 and the conduct of engagements. 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. 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 culture and tone at the top. 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, 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.

One commenter sought clarification on the term “leadership,” including whether it relates only to the specified roles in paragraph .11 and .12, or to all partners and equivalents in the firm. Under QC 1000, leadership is not limited only to those in specified QC roles. While the composition of leadership may vary due to the nature and circumstances of the firm and its engagements and how the firm chooses to organize itself, it includes firm-wide leadership; the executive team; regional, office, and industry segment leadership; and any other levels of leadership the firm may establish. Not all partners or partner equivalents are necessarily leadership; it would depend on the role of the individual.

Firms and firm-related groups were broadly supportive of our proposed quality objectives for governance and leadership. However, several commenters, mostly investors and investor-related groups, urged us to go further in stressing the role of firm leadership and the QC system as a counterbalance to the economic incentives that may drive firms to compromise on quality. Some suggested that compensation plans should weigh quality as much as, or more than, revenue generation. One investor-related group suggested that the standard should increase accountability for the firm and firm leadership’s quality control efforts. Another investor stated that audit quality should be required to be considered at the time of the appointment of firm leadership. One commenter suggested that leadership’s accountability should not be limited to deficiencies and outcomes but extended to acknowledge positive behaviors and processes.

After considering these comments, we revised paragraph .25b to explicitly mention performance evaluation and compensation in the context of defining leadership’s responsibility for quality and holding leadership accountable. We believe this will drive increased clarity about the scope of leadership’s responsibilities and increased accountability for an effective QC system, and will prompt firms to focus on their expectations for leadership behavior and the incentives that drive it. Firms can use a variety of different means to define the responsibility for quality and drive accountability—from firmwide communications and policies to individualized job descriptions, performance targets, promotion criteria, compensation schemes, and sanctions—and can acknowledge both outcome-based and process-based measures and both positive and negative behaviors. The revised quality objective reflects that performance evaluation and compensation play a necessary role in that process.

While we agree with the commenter that quality considerations should be taken into account in the appointment of firm leadership, we believe other quality objectives already address that issue, such as paragraph .44g of QC 1000. Additionally, the criteria for appointing firm leadership may appropriately vary based on the size of the firm and the nature of its practice, so we have avoided being prescriptive in that regard. For example, a larger firm may

have numerous candidates for leadership roles with many criteria considered for appointment, but smaller PCAOB audit practices may have limited personnel eligible for leadership roles.

As noted in the proposal, 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 quality objective emphasizes that a firm's strategic decisions and actions should be consistent with and support the firm's commitment to quality.

One commenter expressed concern that strategic actions may take extended periods of time to yield benefits to quality, and it may be challenging for firms to demonstrate that such actions are consistent with a commitment to quality. We note, however, that this quality objective does not prescribe any specific time horizon, and we believe it is wholly consistent with both short-term measures and long-term investments in technology, training, knowhow, and other means of strengthening a firm's audit practice that may take an extended period to yield measurable improvements.

Some investors and investor-related groups suggested that we require a clear separation of duties between those responsible for audit quality and those responsible for commercial interests. Two of those commenters cited the regulation of credit ratings agencies as an example of appropriate separation of regulated activity and commercial interests.¹⁷³ Another commenter cited with approval the 2007 amendments to the AICPA QC standard, which included application material to the effect that QC leaders should have the authority to implement policies and procedures to ensure that others within the firm will not override those policies to meet short-term financial goals (a concept that does not appear in other QC standards).¹⁷⁴

We considered mandating a greater degree of separation between decision-making about QC and potential commercial motivations, as these commenters suggested, but we do not believe such separation can be achieved by all firms, especially firms with smaller PCAOB audit practices with limited leadership roles. As discussed in more detail below, we are requiring firms with larger PCAOB audit practices to include an element of independent oversight of their QC system. Moreover, we do not believe it would be appropriate to mandate a fully separate or independent QC function. Potential conflicts of interest at the engagement level are addressed in numerous ways in our regulatory scheme: through independence

¹⁷³ See Rule 17g-5(c)(8) under the Exchange Act, pursuant to which ratings agencies are prohibited from having any person who participates in determining or monitoring a credit rating, or developing or approving procedures or methodologies used for determining a credit rating, also participate in sales or marketing or be influenced by sales or marketing considerations. 17 C.F.R. § 240.17g-5(c)(8).

¹⁷⁴ See AICPA, QC Section 10, *A Firm's System of Quality Control*, paragraph .A5.

requirements,¹⁷⁵ ethical requirements of integrity and objectivity,¹⁷⁶ and the basic requirement of professional skepticism, a critical aspect of due professional care.¹⁷⁷ At the firm level, we believe that those conflicts can best be addressed by emphasizing the responsibility and accountability of firm leadership. QC 1000 requires that responsibility for QC reside at the highest levels of firm leadership, and that leaders are evaluated and compensated in a way that creates accountability. In our view, appropriately incentivized firm leadership are best positioned to set the tone and establish a quality-focused culture throughout the firm. Rather than requiring firms to segregate the governance of the firm's audit practice from the firm's other commercial interests, we believe the quality objectives described in paragraph .25 will promote responsibility for and commitment to quality, while allowing firms to develop quality responses appropriate to their particular governance structure.

Lastly, one commenter suggested the governance and leadership component should promote diversity, equity, and inclusion in recruiting talented leaders, a governance body, and auditors. Another commenter suggested leadership can demonstrate its commitment to quality through providing ongoing, meaningful support of scholarly audit and accounting research. We have not revised the standard to reflect these specific suggestions; however, firms may identify quality risks and design and implement quality responses in these areas to achieve the quality objective in paragraph .25a or other quality objectives established by the firm.

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

¹⁷⁵ See PCAOB Rule 3500T, *Interim Ethics and Independence Standards*.

¹⁷⁶ See EI 1000, *Integrity and Objectivity*.

¹⁷⁷ The general principles and responsibilities of the auditor when conducting an audit, including professional skepticism and due professional care, are being reaffirmed and combined in AS 1000, as adopted. See Auditor Responsibilities Release.

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.¹⁷⁸ 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., which did not attract specific comment and is adopted as proposed, will 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 allows 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.¹⁷⁹

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.¹⁸⁰ 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.

¹⁷⁸ 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.

¹⁷⁹ Appendix B includes an example regarding the existence and extent of governance structures providing oversight of leadership. *See* QC 1000.B2.g.

¹⁸⁰ *See* Section IV.C, Roles and Responsibilities, for a discussion of specific roles and responsibilities that are required to be assigned.

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 resources¹⁸¹ 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, which did not draw comment and which we are adopting as proposed, 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.

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 proposal included three specified quality responses in the governance and leadership component, discussed in greater detail below. Some firms and a firm-related group objected generally that the specified quality responses were overly prescriptive and unnecessary, and suggested they should be reformulated as risk-based quality objectives. Other firms generally supported including specified quality responses.

We believe the specified quality responses address important risks that justify specific requirements, and have retained them in the final standard. Firms are required to include these

¹⁸¹ See Section IV.I, Resources, for a discussion of the different types of resources.

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.

Proposed QC 1000 included a requirement for the firm to establish and maintain clear lines of responsibility and supervision within its QC system. A commenter argued that the quality objective in paragraph .25e. is sufficient and the specified quality response was not necessary. While paragraph .27 may address a portion of the firm’s quality response to .25e., we believe paragraph .27 provides additional direction that is appropriate for all firms. Establishing and maintaining structures within the firm—including defining authorities, responsibilities, accountabilities, and supervisory and reporting lines for roles within the firm—will support the effective design and operation of the QC system and the performance of the firm’s engagements, regardless of the size of the firm or the types of engagements it performs. The requirement also complements the documentation requirements of QC 1000.¹⁸²

One commenter expressed concern that this requirement, in combination with the requirements of paragraph .12, could result in a prescriptive, hierarchical approach that would not be desirable or practical. The requirement in the final standard is intended to enhance supervision within the context of firms’ existing QC systems and supervisory structures. It does not require firms to develop or adopt any particular supervisory structure and would be compatible with a range of different approaches, including very flat structures.

The commenter also expressed concern that individuals acting in a supervisory capacity could face liability beyond what exists under Sarbanes-Oxley, which may disincentivize teaming. As discussed in Section IV.C.1.b above, paragraphs .15, .16, and .17 of the final standard prescribe specific supervisory roles within a firm’s QC system, and the individuals who fill those roles are supervisory persons who must exercise reasonable supervision for purposes of Section 105(c)(6) of Sarbanes-Oxley. Additionally, to the extent that other individuals are assigned supervisory responsibilities in light of paragraph .27’s specified quality response, those individuals, like all who are involved in the design, implementation, and operation of the QC system, must exercise due professional care as set forth in paragraph .10 of the final standard.

Another commenter recommended that individuals in supervisory roles should be held liable only for knowing or reckless violations. We note that paragraph .27 does not itself create

¹⁸² See QC 1000.82a. for the documentation requirements related to lines of responsibility and supervision.

responsibilities for supervisory personnel or prescribe standards of liability that apply when those responsibilities are not met. Those issues are addressed elsewhere in our standards and rules, including in the roles and responsibilities component of QC 1000 and PCAOB Rule 3502,¹⁸³ as well as in Section 105(c)(6) of Sarbanes-Oxley.¹⁸⁴ In our view, the requirement to establish and maintain clear lines of authority and supervision primarily serves to clarify how the QC system is structured and how it operates, by laying out clearly the authorities, responsibilities, accountabilities, supervisory and reporting lines, and who is responsible for each element of the QC system. If the requirement has consequences in terms of individual accountability and liability, that would only be because it removes any doubt about which individuals are acting in a supervisory capacity and the scope of their respective responsibilities, thereby clarifying how these other provisions should be applied.

We are adopting this requirement as proposed.

.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 external oversight function for the QC system composed of one or more persons who are not partners, shareholders, members, other principals, or employees of the firm and do 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 (an "External QC Function" or "EQCF"). The EQCF should have the experience, competence, authority, and time necessary to enable them to carry out the responsibilities assigned to the EQCF by the firm. The responsibilities of the EQCF should include, at a minimum, evaluating the significant judgments made and the related conclusions reached by the firm when evaluating and reporting on the effectiveness of its QC system.

¹⁸³ See PCAOB Rule 3502. The Board has proposed to amend Rule 3502 to change the standard of conduct for associated persons' contributory liability from recklessness to negligence and to provide that an associated person contributing to a violation need not be an associated person of the registered firm that commits the primary violation. See PCAOB Rel. No. 2023-007.

¹⁸⁴ 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, *Commencement of Disciplinary Proceedings*, at (a)(2); see also, e.g., *In the Matter of Scott Marcello, CPA*, PCAOB Rel. No. 105-2022-004 (Apr. 5, 2022) (imposing sanctions under Section 105(c)(6)); *In the Matter of WWC, P.C.*, PCAOB Rel. No. 105-2022-006 (Apr. 19, 2022) (same); *In the Matter of KPMG Inc., Cornelis Van Niekerk, and Coenraad Basson*, PCAOB Rel. No. 105-2022-015 (August 29, 2022) (same).

The proposal included a specified quality response to incorporate an oversight function for the audit practice including at least one person from outside the firm, which would apply to firms that issue audit reports with respect to more than 100 issuers. See Section III.C, Scalability, for a discussion of the 100-issuer threshold.

Comments were mixed on the need for and potential breadth of this requirement. We received several comments, primarily from investors and investor-related groups, suggesting that the proposed requirement did not go far enough. Some commenters stated that the oversight function should not be limited to one individual but instead a larger number (such as three) of independent non-employee members should be required, or potentially an advisory council or committee of the firm's board of directors with multiple or even a majority of independent non-employee members. Some of these commenters asserted that requiring only one person with undefined authority to serve in an oversight role makes it unlikely to be effective and falls short of the 2008 recommendations of the U.S. Treasury Department's Advisory Committee on the Auditing Profession, which suggested consideration of "firms appointing independent members with full voting power to firm boards and/or advisory boards with meaningful governance responsibilities."¹⁸⁵ One commenter objected that the requirement only mandates practices that are already in place at the largest firms, and so will not generate any change. Another commenter asserted that there is little merit in requiring an independent member of the firm's oversight function without also considering the balance of the oversight function and the contribution of the independent member. Others called for more specificity about the individual's role, including specific powers, such as the power to meet with firm management and obtain relevant information. Some investor-related groups also called for transparency on the role of the non-employee members.

Many commenters, including some larger firms, supported the oversight role. Two commenters suggested that the requirement for an independent oversight function be extended to apply to all firms that issue audit reports for issuers and one of these commenters suggested having firms consider whether an independent function is an appropriate response to achieving the quality objectives.

Other commenters, including some mid-sized firms, did not support the specified quality response and suggested it should be a quality objective instead. One firm suggested that the objective could be better accomplished by designating an "audit quality expert" on a firm's board (similar to a "financial expert" on an audit committee) or by hiring independent external QC advisers. Some commenters expressed concern about the lack of specificity and clarity regarding the role, including questions regarding the individual's authority and function. One noted that the individual was not required to be a CPA and asserted that the need for and benefits of the role had not been sufficiently articulated; on that basis, the commenter did not

¹⁸⁵ U.S. Treasury Department, *Advisory Committee on the Auditing Profession Final Report* (Oct. 6, 2008) at VII.8.

support it. Another commenter did not see the linkage between the specified quality response and the quality objectives and suggested that the lack of definition of the role, coupled with a lack of clarity about which quality objectives were being addressed, would make implementation challenging. Other commenters stated that finding individuals to fill this role may be challenging.

Some commenters requested guidance on how to implement the requirement, including with respect to the qualifications or roles of the individuals. One firm sought clarity on whether supervisory liability under Sarbanes-Oxley Section 105(c)(6) would apply equally to members with an oversight or advisory function. Some commenters, including firms, expressed concern about the potential scope and meaning of the terms such as “governance structure,” “independent judgment,” and “oversight function,” and requested confirmation that current practices such as independent advisory boards are a permissible approach. One firm requested an extended implementation period to allow time for firms to design and implement the oversight function, including identifying and onboarding appropriate individuals.

Based on the comments received, we have refined the proposed requirement to provide additional specificity and clarity. The final rule refers to an “external oversight function for the QC system composed of one or more persons,” none of whom has a disqualifying relationship with the firm. This more precise language clarifies that the focus is on the QC system and emphasizes that the function is to be carried out entirely by one or more persons external to the firm, who are not principals or employees of the firm and do not have any other relationship with the firm that would interfere with the exercise of independent judgment with regard to QC-related matters. We have also added a name for the position—External QC Function, or EQCF—which we believe clarifies and underscores that the person or persons are external to the firm and serve in a QC-focused role.¹⁸⁶ We have also conformed the provision to the descriptions in QC 1000.12 of other specified QC system roles by providing that the EQCF should have the experience, competence, authority, and time necessary to enable them to carry out the responsibilities assigned to them by the firm.

To clarify what is entailed in “an external oversight function for the QC system,” the final standard also specifies a baseline requirement that the EQCF’s responsibilities should include evaluating, at a minimum, the significant judgments made and the related conclusions reached by the firm when evaluating and reporting on the effectiveness of its QC system. We believe this addition is responsive to commenters who requested clarification of the proposal, as well as those suggesting that the standard include some specific requirements with respect to the role. We expect that firms will make a number of significant judgments in performing and reporting on their QC system evaluation. We expect that the person or persons serving in this

¹⁸⁶ Firms may assign other functions to the person or persons serving in the EQCF role so long as the specified QC function can be carried out as set forth in the standard and discussed in this release.

external oversight function will evaluate judgments made by firm personnel in the firm's evaluation of the firm QC system and the required reporting.

The evaluation performed by the EQCF will be in some respects analogous to the EQR's evaluation of significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report.¹⁸⁷ Like the EQR, the EQCF will review and evaluate work performed by others, not redo the work, and must exercise due professional care in performing their responsibilities.¹⁸⁸

However, there are important differences between the requirements for the EQR and the EQCF. Unlike the EQR standard, QC 1000 does not impose specific limits on the length of service of the EQCF, though firms should consider the potential for arrangements relating to length of service, such as term limits and protections against removal, to prevent the creation of a relationship with the firm that impairs independent judgment. QC 1000 also does not specify the procedures the EQCF should perform to evaluate the significant judgments made and related conclusions reached. These may vary based on the circumstances of the firm and the design, implementation, and operation of its QC system, but must be sufficient to enable the EQCF to perform their evaluation with due professional care. In addition, unlike the EQR standard, QC 1000 does not require that the EQCF provide concurring approval of reporting, although firms would be free to establish such concurring approval as a matter of policy. Documentation will have to be prepared and retained in sufficient detail to evidence how the quality response operated.¹⁸⁹ This will form part of the QC documentation supporting the firm's ongoing risk assessment and monitoring and remediation efforts, as well as our own oversight activities. Under QC 1000.65, firms will be required to consider the EQCF's evaluation in their ongoing monitoring of the QC system (including monitoring of the evaluation process).

Separately, we carefully considered commenter suggestions to increase the required number of independent individuals and to establish specific eligibility criteria for them. Given the oversight responsibility of an EQCF, we believe at least one person is always necessary and firms may determine, based on their circumstances, that more than one person is needed to appropriately carry out the function. We believe the requirement will respond to the quality objective in paragraph .25e by ensuring an independent perspective on QC matters, but it does not supplant firm leadership or relieve them of their fundamental responsibility to instill and maintain a firm culture that appropriately prioritizes QC. Accordingly, we do not believe it would be appropriate to mandate a specific number of individuals or the specific credentials

¹⁸⁷ See AS 1220.09.

¹⁸⁸ See QC 1000.10; AS 1220.12.

¹⁸⁹ See QC 1000.83b. We expect such documentation to include both (1) how the EQCF evaluated the significant judgments made and the related conclusions reached by the firm when evaluating and reporting on the effectiveness of its QC system and (2) the results of the EQCF's evaluation.

they must have (besides their ability to exercise independent judgment with regard to matters related to the QC system and the general requirement that they have the experience, competence, authority, and time necessary to enable them to carry out their assigned responsibilities). Rather, the decision will be based on specific skillsets of the person or persons in this function to be able to carry out the requirements of the function. In that regard, firms may conclude that one or more persons appointed to the EQCF should be non-auditors to bring a greater diversity of perspectives to the function.

Beyond the minimum responsibilities specified in the standard, we are giving firms flexibility in establishing other responsibilities of the EQCF, enabling the function to best respond to the nature and circumstances of the firm. For example, if the firm has experienced an increase in recurring engagement deficiencies, the firm may charge the EQCF with reviewing and evaluating the firm's remediation actions and monitoring plan. As another example, a firm may assign the EQCF with strategic responsibilities, such as maintaining situational awareness through the identification and monitoring of emerging risks or trends that could potentially affect the firm's QC system. While QC 1000 specifies that the EQCF exercise oversight over the QC system, the firm may also choose to extend its authority more broadly. The responsibilities assigned to the EQCF will in turn drive decisions about the scope of the EQCF's authority. At a minimum, that will entail sufficient access to information, documentation, and firm personnel to enable evaluation of the significant judgments made and the related conclusions reached by the firm when evaluating and reporting on the effectiveness of its QC system, but it could be broader depending on the scope of the EQCF's responsibilities as assigned by the firm.¹⁹⁰ Consideration of the experience, competence, and time necessary to serve in the role will likewise depend on the responsibilities assigned by the firm.

The firm may consider many matters when establishing an EQCF. Such matters could include:

- The responsibilities assigned by the firm to the EQCF, including those specified in QC 1000;
- The qualifications required of the individual(s) assigned to fulfill those responsibilities, including those specified in QC 1000;
- The scope of authority afforded to the EQCF in light of the assigned responsibilities;

¹⁹⁰ The scope of firm policies and procedures regarding the EQCF will also depend on its role and the associated risks. For example, pursuant to QC 1000.53g, firms will have to develop policies and procedures regarding information communicated to and obtained from the EQCF.

- Whether to establish a direct line of communication from the EQCF to the individual assigned ultimate responsibility and accountability for the QC system as a whole, or the individual assigned operational responsibility for the QC system as a whole, or both;
- Whether to require that the EQCF comply with independence requirements applicable to auditors;¹⁹¹
- The level of external transparency of the EQCF's role and responsibilities;
- The compensation structure for the EQCF; and
- The term of service for the EQCF, including restrictions on removal and limits on length of service.

In making these determinations, the firm should be mindful of the requirement that members of the EQCF not have any relationship with the firm that would interfere with the exercise of independent judgment with regard to matters related to the QC system.

The EQCF could be, but would not be required to be, in the “chain of command” under the SEC independence rule.¹⁹² We do not believe that the EQCF would be a “supervisory person” under Sarbanes-Oxley Section 105(c)(6) solely by virtue of having evaluated the significant judgments made and related conclusions reached by the firm when evaluating and reporting on the effectiveness of the firm's QC system. However, depending on the nature and degree of their responsibility, ability, or authority to affect the conduct of the firm's associated persons, as established by the firm, the EQCF could be subject to Sarbanes-Oxley Section 105(c)(6).

We are not requiring the results of the EQCF's evaluation to be publicly disclosed.¹⁹³ However, nothing set forth in this release would limit or prohibit firms from disclosing any information about the EQCF's activities—including the EQCF's practices, methods, or procedures, or the manner or results of the EQCF's evaluation—if the firm so chooses.

¹⁹¹ See Regulation S-X Rule 2-01(b)-(c), 17 C.F.R. § 210.2-01(b)-(c), and PCAOB Rules under Section 3, *Auditing and Related Professional Practice Standards*, Part 5-Ethics and Independence.

¹⁹² See Regulation S-X Rule 2-01(f)(8), 17 C.F.R. § 210.2-01(f)(8).

¹⁹³ For a discussion of certain legal constraints imposed by Sarbanes-Oxley on the Board's ability to require public disclosure of certain QC-related information, see Section IV.L.1.c.ii. As part of a separate project, the Board has proposed a requirement for firms that have an EQCF to disclose the identity of the person or persons, an explanation for the basis of the firm's determination that each such person is independent of the firm (including the criteria used for such determination), and the nature and scope of each such person's responsibilities. See PCAOB Rel. No. 2024-003.

Based on comments received and experience with inspections of firms' systems of quality control, we believe that investors, audit committees, and other stakeholders will benefit from the EQCF's evaluation even in the absence of public disclosure. An external oversight function should enhance the discipline with which the firm carries out its own QC system evaluation. As we observe the implementation and performance of the EQCF through our inspection activities, we may publish observations or good practices. For these reasons, we believe that the EQCF will support improvements in firms' systems of quality control, ultimately benefiting investors, audit committees, and other stakeholders.

.29 The firm should design, implement, and maintain policies and procedures for addressing 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, and other participants*. Such policies and procedures should be made available to all *firm personnel and other participants* and address:

- a. Processes and responsibilities for receiving complaints and allegations from internal and external parties (for example, policies and procedures regarding a complaints mailbox or hotline or a whistleblower program);
- b. Protecting persons making complaints and allegations from retaliation;
- c. Investigating and addressing complaints and allegations; and

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

- d. If the firm issued audit reports with respect to more than 100 issuers during the prior calendar year, providing a confidential and anonymous process for submitting complaints and allegations and protecting the confidentiality of the individuals and entities that made a complaint or allegation during the investigation.

People internal and external to the firm can help a firm identify instances of noncompliance with applicable professional and legal requirements earlier than might be possible through the firm's own monitoring.¹⁹⁴ The proposal included a specified quality response requiring policies and procedures for addressing potential noncompliance with

¹⁹⁴ In addition, through this process information may be received regarding noncompliance with laws and regulations by companies that engage the firm.

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.

This would include clearly defining channels within the firm that enable reporting of complaints and allegations by firm personnel and external parties (e.g., employees of companies or other participants) and establishing procedures for appropriately investigating and addressing such complaints and allegations, including complying with any applicable reporting or other requirements.¹⁹⁵

The proposal sought comment on the appropriateness of this specified quality response, and whether any additional specified quality responses should be considered. Two firms that commented supported the specified quality response. Two other firms expressed concern with the prescriptiveness of other participants being included in the requirement. One investor suggested there should be an explicit requirement for a whistleblower mechanism with key protections such as confidentiality and protection against retaliation, and that the individual responsible for the firm's QC system be responsible for the investigation of whistleblower complaints and remediation of QC issues identified by whistleblowers.

We are adopting the specified quality response with some modifications, described below. We believe that establishing policies and procedures that support the reporting and investigation of potential noncompliance will assist firms in complying with applicable professional and legal requirements. It will also assist them 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. Finally, it may result in firm personnel or external parties identifying and communicating deficiencies in the QC system.

The final provision retains the reference to other participants, as we believe it is important for the firm to capture any potential noncompliance with applicable professional and legal requirements, including with regard to work performed by other participants that relates to the firm's QC system or the firm's engagements.

We have expanded the requirements related to the firm's policies and procedures for collecting and addressing complaints and allegations to explicitly require that they:

¹⁹⁵ A firm's program for addressing complaints and allegations may be subject to requirements under applicable law regarding whistleblowers (such as, for example, N.Y. Labor Law Section 740). However, such a 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. To the extent a firm's program for addressing complaints and allegations provides protective measures, such as confidentiality and non-retaliation, based only on firm policy and not on law, such protective measures may not create legally enforceable rights.

- be made available to all firm personnel and other participants;
- address processes and responsibilities for receiving, investigating, and addressing complaints and allegations; and
- include protecting persons making complaints and allegations from retaliation.

We also expanded the specified quality response to require firms that issued audit reports with respect to more than 100 issuers during the prior calendar year to include confidentiality protections in their policies and procedures.

The firm's policies and procedures regarding complaints and allegations should be made available to all firm personnel and other participants, which could occur by posting them on an intranet site or providing such policies and procedures to other participants upon engagement. The policies and procedures should include identifying who is responsible for receiving, investigating, and addressing complaints and allegations; describing the process for submitting complaints and allegations; and describing how the firm will investigate and address complaints and allegations received. We also specified that the policies and procedures should explicitly address protection against retaliation of persons making complaints and allegations, which we believe is a critical element of any effective program for receiving complaints and allegations.

The required policies and procedures regarding investigating and addressing complaints and allegations 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.

For firms that issued audit reports with respect to more than 100 issuers during the prior calendar year, the policies and procedures will have to provide a confidential and anonymous submission process for complaints and allegations, similar to the requirements for audit committees under the Exchange Act.¹⁹⁶ For example, a firm may have a confidential and anonymous submission process through a website, toll-free number, or mobile app, and could manage the process in-house or through a third-party provider. The firm's policies and procedures will also have to provide for protection, during the investigation, of the confidentiality of individuals and entities who make complaints and allegations. We believe this requirement specifically targets and responds to potential quality risks that are more likely to arise in audit practices of a certain size and complexity. However, firms that are not subject to this express requirement may nevertheless determine that such requirements are a necessary or appropriate quality response to address their quality risks.

¹⁹⁶

See Exchange Act Section 10A(m)(4).

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;¹⁹⁷
- 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;¹⁹⁸ 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.¹⁹⁹

F. Ethics and Independence

This component addresses the fulfillment of firm and individual responsibilities under relevant ethics and independence requirements. 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.

The ethics and independence component of the standard has been tailored to the ethics and independence requirements that apply to engagements performed under PCAOB standards. Under the standard, ethics and independence requirements 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).²⁰⁰ We have clarified that the reference to other applicable requirements is

¹⁹⁷ See QC 20.04.

¹⁹⁸ See SECPS § 1000.46.

¹⁹⁹ See SECPS § 1000.08(l).

²⁰⁰ Footnote 10 to QC 1000 provides:

Ethics and independence requirements include PCAOB independence and ethics standards and rules, the U.S. Securities and Exchange Commission (“SEC”) rule on

limited to those that are relevant to fulfilling auditor obligations and responsibilities in the conduct of engagements or in relation to the QC system. The standard requires firms to establish quality objectives related to ethics and independence requirements and design and implement specified quality responses.

1. QC 1000

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

a. Ethics and independence quality objectives

The standard requires 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. Adherence to standards of professional ethics is as important as adherence to requirements regarding auditor independence, and firms' QC systems should address both. Under the standard, firms are required to establish quality objectives that

auditor independence, and other applicable requirements regarding accountant ethics and independence that are relevant to fulfilling their obligations and responsibilities in the conduct of *engagements* or in relation to the QC system, 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.*

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 also has responsibility and plays a critical role in ensuring that individuals understand those requirements and have the tools and resources they need to comply.

One firm suggested that the Board clarify the ethical requirements that are subject to the responsibility of the individual assigned operational responsibility for the firm's compliance with ethics and independence requirements. The firm specifically commented that competence and due care are characteristics required by both ethical standards and QC standards, and as a result, there could be confusion over whether such requirements are ethical requirements or quality control requirements when determining the responsibility of the individual assigned operational responsibility for the firm's compliance with ethical and independence requirements. In some cases, a matter may be applicable to the responsibilities of both the individual assigned operational responsibility for the firm's compliance with ethics and independence requirements and the individual assigned operational responsibility and accountability for the QC system as a whole. A firm could divide responsibilities based on the specific issues involved, so long as the lines of responsibility are clear (for example, duties of competence and due care in the context of the audit, codified under our ethics rules, could be assigned to the individual with operational responsibility for compliance with ethics and independence requirements, while duties of competence and due care in the context of QC system activities, codified in QC 1000, could be assigned to the individual with operational responsibility for the QC system).

Under the standard, the firm is required to establish a quality objective to identify conditions, relationships, events, and activities that could result in violations of ethics and independence requirements and evaluate and respond to such conditions, relationships, events, and activities on a timely basis. This will 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. One firm commented that as the proposed quality objectives for ethics and independence are broadly consistent with other jurisdictional and international quality control/management standards, it believes that they are appropriate, and no further changes are needed.

An investor-related group expressed concern that the proposal did not sufficiently address conflicts of interest, such as when an audit firm performs other services for the audited company. The investor-related group further commented that without clear separation

between those responsible for quality control and those responsible for maintaining client relationships and winning consulting contracts, investors can have less than full confidence the system of quality control will ensure the necessary level of audit quality. We acknowledge that QC 1000 does not create new requirements regarding auditor independence. However, in relation to the commenter's specific concern about the performance of non-audit services, QC 1000 requires the QC system to operate over compliance with numerous restrictions on non-audit services that exist under current independence rules enacted in response to previous independence conflicts.²⁰¹

QC 1000 establishes quality objectives that apply to all firms. Within the ethics and independence component, firms are required to establish quality objectives that address both personal and firm-level compliance. Personal violations 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."²⁰² Firm-level violations include such matters as providing prohibited services or failing to obtain required audit committee pre-approval. We have also included specified quality responses that directly address the firm's policies and procedures for identifying and monitoring firm and personal relationships with audit clients to help mitigate the risk of potential violations. In addition, the roles and responsibilities requirements direct firms to assign an individual operational responsibility for the firm's compliance with ethics and independence requirements to provide oversight specifically focused on this area.

The quality objectives 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" as defined in PCAOB rules²⁰³ or "covered persons in the firm" under the SEC independence rule.²⁰⁴ 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 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 system align with, and do not go beyond, the ethics and independence requirements over which the QC system would operate, in this component we 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

²⁰¹ See, e.g., Regulation S-X Rule 2-01(c)(4), 17 C.F.R. § 210.2-01(c)(4); PCAOB Rules 3522-3526.

²⁰² See Regulation S-X Rule 2-01(f)(11), 17 C.F.R. § 210.2-01(f)(11).

²⁰³ See PCAOB Rule 1001(p)(i).

²⁰⁴ 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.

participants,” in this component the quality objective addresses compliance by “others subject to [ethics and independence] requirements.”

One firm commented that it supported the direction of the quality objectives, but asserted that some of the terms were confusing as it related to “others subject to ethics and independence requirements.” The firm questioned whether these correspond to other participants as defined in the standard. The firm further commented that the terminology used for others subject to ethics and independence requirements could create operational challenges because those terms are open to interpretation, and requested that the Board clarify the language the standard used. The firm suggested that the proposed requirements that contain this language could go beyond the intended applicability of the independence rules to the various parties contemplated. Again, we use terminology in this component that incorporates or refers back to the terminology used in ethics and independence rules, terminology which we believe is well understood in those contexts. We use it precisely to avoid going beyond the scope of existing ethics and independence requirements, and to ensure that QC 1000 addresses exactly the same population as the ethics and independence rules themselves.

One firm commented that while the proposed quality objectives for ethics and independence are appropriate and important, further clarification may be needed of how the objectives apply to firm personnel. Specifically, the firm argued that it could be inferred that the ethics and independence requirements extend to all individuals involved in the operation of the firm’s QC system, including those individuals who are not subject to the requirements under the existing PCAOB and SEC independence rules, for example, data research teams. QC 1000 does not impose ethics and independence requirements on individuals who are not currently subject to them. References in the standard to “requirements” and “obligations” are to existing requirements and obligations which themselves specify to whom they apply. However, firms may choose to implement broader policies regarding ethical behavior that impose requirements on individuals who are not subject to the ethics and independence rules of the PCAOB and the independence rule of the SEC.

With respect to the timing of communication of violations to the individual assigned operational responsibility for the firm’s compliance with applicable ethics and independence requirements, the quality objective states that such actions should take place on a timely basis. One firm agreed that timely communication of ethics and independence related matters within the firm is important for audit quality, but expressed concern that the prescriptive nature of the requirements addressing communications may detract from the achievement of the intended objectives. The firm suggested that it is important to recognize that the evaluation of certain matters would be done in accordance with the firm’s policies and procedures, which are designed to strike a balance between prematurely alerting individuals to matters for which the facts and potential impacts are not sufficiently known and making sure those with ultimate responsibility for decisions are made aware on a timely basis. The final standard does not

specify that all violations need to be communicated immediately. However, we believe timely communication and 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, communication and action may have to be immediate to be timely.

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 specified quality responses are primarily 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.²⁰⁵ We are incorporating these SECPS member requirements into QC 1000, with some refinements, and extending those requirements to all firms. Our view is that the 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 is appropriate to extend the SECPS requirements to all firms.

Under the standard, the firm is 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.

One firm commented that it generally supports the specified quality responses and believes that it is appropriate to have the same set of independence requirements apply for all firms. Another firm suggested that the specified quality responses are not necessary to achieve the objectives of QC 1000. Instead of prescriptive specified responses, the firm suggested that

²⁰⁵ See SECPS § 1000.46.

the standard include more specified quality objectives which would promote scalability and allow for future adaptations to technological or other innovations. Another commenter said that the proposal expanded on the independence requirements in a granular manner, and suggested that the details be moved into an appendix or practice aid, or provided as additional guidance to help reduce differences between QC 1000 and other standard setters. The specified quality responses for the ethics and independence component primarily carry forward existing requirements from our QC standards and extend certain existing requirements to all firms. We believe that the specified quality responses relate to risks that apply to all firms and therefore should be addressed by all firms. We intend them to be obligations of all firms and have therefore codified them within the rule text rather than as guidance.

i. **QC policies and procedures about general ethics and independence matters**

The standard requires 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 proposed requirement did not draw comment and is adopted as proposed.

The phrase “may reasonably be thought to bear on independence” is used in PCAOB Rule 3526²⁰⁶ and should be familiar to all firms. It is taken from an independence standard that predates the existence of the PCAOB,²⁰⁷ 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 independence.²⁰⁸ The firm’s policies and procedures are required to address all matters that

²⁰⁶ See PCAOB Rule 3526 (requiring auditors to describe to the audit committee relationships that may reasonably be thought to bear on independence).

²⁰⁷ 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.

²⁰⁸ See Regulation S-X Rule 2-01(b), 17 C.F.R. § 210.2-01(b).

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 non-exclusive list of circumstances that the SEC considers to be inconsistent with independence.²⁰⁹ 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.²¹⁰

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 companies for which the firm performs *engagements*, 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;

The proposed requirements did not draw comment and are adopted substantially as proposed.

Integrity and objectivity are important ethical concepts currently addressed in QC 20.²¹¹ 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.

²⁰⁹ See Regulation S-X Rule 2-01(c), 17 C.F.R. § 210.2-01(c).

²¹⁰ See PCAOB Rule 3522, *Tax Transactions*; PCAOB Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*.

²¹¹ See QC 20.10.

As discussed in more detail in Section V.B., we are rescinding our interim ethics and independence standard, ET 102, *Integrity and Objectivity*, and replacing it with a new standard, EI 1000, *Integrity and Objectivity*.²¹² QC 1000 includes a reference to that new rule and to PCAOB Rule 3500T, *Interim Ethics and Independence Standards*.

The final standard clarifies that firm personnel are 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;

The proposed requirement did not draw comment and is adopted as proposed.

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.²¹³

We are expanding 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. We believe the specific focus on identifying matters requiring consultation should prompt firm personnel and others subject to such requirements 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 are applying 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, *firm personnel*, affiliates of the firm, and,

²¹² See Section V.B, Rescission of ET Section 102; adoption of EI 1000; related amendments.

²¹³ See SECPS § 1000.46 (requirement 5).

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.²¹⁴ 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. One firm requested clarification of whether auditing, on a sample basis, selected information such as brokerage statements, will be mandatory under QC 1000. The standard does not prescribe specific activities to monitor compliance with ethics and independence requirements and the firm's ethics and independence policies. This allows 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 standard. While auditing brokerage statements is not mandatory under QC 1000, the firm must design, implement, and maintain policies and procedures to monitor compliance with applicable ethics and independence requirements and related firm policies and procedures. Based on the firm's size and specific circumstances, a firm can choose which monitoring activities are an effective response to meet the quality objective.

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 bright-line policies and reducing the range for individual judgment. Under the standard, the

²¹⁴ See SECPS § 1000.46 (requirement 7.d).

firm's evaluation of compliance covers 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, and 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 others performing work on behalf of the firm who are subject to such requirements 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).

The proposed requirements are adopted substantially as proposed.

As previously discussed, QC 1000 includes the existing SECPS requirement for firms to have policies and procedures that address independence violations and expands the requirement to cover all firms and to include ethics violations.

Under the standard, the firm is 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 are 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 are 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. While one firm supported bringing greater attention and accountability to the ethics and independence component, it suggested that the level of prescription may create operational challenges that could be detrimental to audit quality. Specifically, with regards to paragraph .33f.(2), the firm commented that ethical or independence violations may take a variety of forms and that dictating that preventive and corrective actions must be taken does not promote a risk-based approach. The standard requires that a firm's policies and procedures address, with respect to violations and potential violations, the taking of preventive and corrective actions, as appropriate. Ethics or independence violations may take a variety of forms, and therefore the nature and extent of the preventive and/or corrective actions may also take a variety of forms commensurate to the severity and pervasiveness of the violation.

The firm's policies and procedures are required to address reporting of ethics and independence violations. QC 1000 requires that firm personnel and others performing work on behalf of the firm that are subject to the ethics and independence requirements report both their own violations and other violations of which they become aware that may affect the firm. We revised the language in proposed paragraph .33f.(3) to clarify that the requirement applies to others performing work on behalf of the firm that are subject to the ethics and independence requirements.

The standard takes a principles-based approach, which allows 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.²¹⁵ 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 are 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

²¹⁵ See, e.g., paragraph .29 of QC 1000, discussed in Section IV.E. above, for requirements regarding firm processes for addressing complaints and allegations.

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 and ethics certifications, and matters requiring audit committee pre-approval

Under the standard, the firm's policies and procedures on matters that may reasonably be thought to bear on the independence of the firm are required to address, among other things, (1) restricted entities, including the maintenance and dissemination of the list of restricted entities; (2) independence and ethics 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, the process to identify investments in securities that might impair the independence of the firm or such *firm personnel* must 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 the process to identify investments in securities that might impair the independence of the firm or such *firm personnel*, 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, for example, 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.

Most of the requirements related to restricted entities come from existing SECPS member requirements,²¹⁶ which will now apply to all firms. Under the standard, as under current requirements, restricted entities include all audit clients (including affiliates of the audit client) of the firm and affiliates of the firm. One firm commented that the proposal did not define “affiliates” and recommended either referencing the definition provided in PCAOB Rule 3501 or defining the term in the standard in a manner similar to Rule 3501. “Audit client,” “affiliate of the audit client,” and “affiliate of the accounting firm” are terms defined in existing PCAOB and SEC rules.²¹⁷ As proposed, paragraph .34 includes a footnote referring to those definitions.

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.²¹⁸ As proposed, we are requiring an automated system for 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 requirements to have an automated system and Regulation S-X Rule 2-01(d).²¹⁹ Firms that issued audit reports for 100 or fewer issuers are required to consider whether the system needs to be automated, taking into account the

²¹⁶ 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.

²¹⁷ “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 the 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).

²¹⁸ See SECPS § 1000.46 (requirement 4).

²¹⁹ 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.

quality risks and the nature and circumstances of the firm. For example, a firm with close to 100 issuers 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.

One firm commented that the specified quality response to have an automated process for identifying direct or material indirect financial interests is appropriate, and another firm commented that it did not object to the requirement. However, a firm and a firm-related group recommended that the PCAOB consider if the existing SEC requirements are sufficient such that no additional PCAOB requirements are needed, and several firms commented that the costs of implementing the requirement would be significant and instead the threshold should be increased to 500 issuers to be consistent with the SEC requirements. Some of these firms suggested that the cost may be a potential barrier to entry for firms approaching the 100-issuer audit client threshold. One of these firms commented further that some firms that audit over 100 issuers will consider decreasing the size of their practice due to the associated cost of the requirement. This firm suggested that the specified quality response be removed and instead, if necessary, implement a quality objective that firms could address through their risk assessment process. Several firms suggested that firms that audit more than 100 but no more than 500 issuers could consider implementing such a process, but it should not be required. One firm-related group suggested that the threshold for requiring an automated independence system be reduced further, given the number of repeated independence issues among all firms.

One firm expressed concerns with both the proposed requirement in paragraph .34a.(1) and the suggestion in paragraph .34a.(2) to automate this process, suggesting that this would be cost prohibitive and firms should design processes that reflect their respective size, complexities and risks identified. Another firm commented that firms subject to the current SECPS requirements have likely invested significant capital and resources to implement and maintain tools that enable compliance with those requirements, and while the firm views that investment as worthwhile and believes the procedures have contributed to audit quality over the years, it expressed concerns for the cost of the requirement to firms that audit between 100 and 500 issuers. Another firm commented that it has such an automated system in place, however it suggested that the implementation of such a system within the timeframe set out in the proposed standard may be challenging and costly. One firm commented that the determination of whether or not to implement an automated process for identifying and tracking direct and material indirect financial interests should be risk-based and not include a prescriptive requirement based on an arbitrary count of greater than 100 issuers. The firm specifically commented that the size, scope, nature, and complexity of firms' issuer practices can vary significantly among the annually inspected firms, noting for example that a large portion of its issuer client count consists of Form 11-K audits and smaller reporting companies. Another firm commented that while the size of the firm's client base is one factor to consider in determining an appropriate quality response, the nature and circumstances of the firm and the

firm's clients are also factors that should be taken into consideration, as well as the firm structure, industries served, and number of managers and partners.

Some firms sought clarity as to whether an automated process would be required for other financial relationships, for example, employment relationships, business relationships, or non-audit services, and commented that the identification of certain financial relationships cannot be easily automated. Instead, the firms suggested limiting the requirement to automate the process for identifying investments in securities that might impair independence, to align with the SEC requirement. A number of firms and a firm-related group requested clarity on what "automated" means and what the Board's expectations are with regards to the nature, extent and scope of automation.

After consideration of the comments, we are adopting the 100-issuer threshold as proposed. We believe it is important to maintain a consistent threshold for the incremental requirements in QC 1000. As discussed in more detail in Section III.C. above, we believe that the 100-issuer threshold is appropriate, and while the nature of each firm's audit client list may vary, there still exist complexities inherent to firms with a large number of issuer audit clients that may give rise to quality risks that apply to the firm's independence, for which the automated system would be an appropriate quality response.

We have clarified in the final standard that the requirement for an automated process is limited to the process to identify investments in securities that might impair the independence of the firm or firm personnel, the same scope as required under Regulation S-X Rule 2-01(d). We have observed through our oversight activities that some firms have systems that automate the identification of their professionals' investment holdings through direct broker feeds, but a direct broker feed is not the only type of automated process that would meet our requirement. As discussed in a December 9, 1999, letter from the SEC's Chief Accountant,²²⁰ firms need to develop a system that tracks audit engagements and financial investments held by professionals such that the conflict verification process is automated. Such a system may rely on firm professionals accurately self-reporting and entering their investments into the system in a timely manner. These holdings would automatically be compared to the list of restricted entities to identify any relationships with restricted entities. Based on the size of the firm and other characteristics, a firm may determine that a direct broker feed is an appropriate quality response (for example, if the firm's monitoring activities found high rates of non-compliance by firm personnel with the firm's policies and procedures for reporting financial investments), but a direct broker feed is not expressly mandated for firms subject to the requirement to implement an automated process. We also made a change to require that the process

²²⁰ See Letter From the Chief Accountant: Issues Related to Independence/Quality Control to SEC Practice Section (II) (Dec. 9, 1999), available at <https://www.sec.gov/info/accountants/staffletters/calt129a.htm>

described in paragraph .34a.(1) must be automated to conform the degree of responsibility that the requirement imposes on the auditor to that required under paragraph .34.

One firm suggested that a longer transition period be provided for firms that are not currently subject to a requirement to implement an automated system. The firm commented that if two firms merged and one or both of the firms had previously not been subject to the requirement, it is unlikely that a system of this nature could be implemented and tested for effectiveness in the time period provided. We believe that firms continuously monitor the size of their audit practice relative to the 100-issuer threshold, and if a firm is considering a transaction such as a merger that would increase its number of issuer audit clients significantly, then the firm could begin to implement such a system in advance of the end of the calendar year in which the firm first surpasses the 100-issuer threshold. Indeed, for a transaction such as a merger of audit firms, we believe that there could exist specific risks to independence as a result, which in itself may result in a firm developing an automated system as a quality response.

- 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, at least monthly (and more frequently, if appropriate), additions to the list of restricted entities to *firm personnel* and others performing work on behalf of the firm whose relationships and arrangements with such additional restricted entities may reasonably be thought to bear on the independence of the firm.

- 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 additions 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;

Current SECPS requirements require timely (generally monthly) communication of additions to the Restricted Entity List.²²¹ The proposal contemplated requiring that firms have policies and procedures for 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, and updating and communicating changes to the list of restricted entities at least monthly to such persons.

Several firms and a firm-related group suggested the specified quality response be replaced with a quality objective regarding updates to and awareness of changes in the restricted entity list. Two of these firms suggested that the requirement be amended to limit communications to additions to the restricted entity list. Another firm suggested communications be limited to firm personnel subject to independence requirements and the requirements should allow for flexibility in the nature, timing, and extent of communications. QC 1000 does not enlarge the population of individuals who are subject to ethics and independence requirements. References in the standard to "requirements" and "obligations" are to existing requirements and obligations which themselves specify to whom they apply. In addition, after consideration of the comments received, we have amended the standard to limit the required communications to additions to the list of restricted entities, rather than all changes.

Some firms did not support this communication to "others performing work on behalf of the firm," and suggested that communications should be limited to potential covered persons affected by the additions. Two of these firms commented that these individuals would likely not be considered covered persons for engagements other than the engagement they are working on, and suggested that the Board allow firms to take a risk-based approach when determining the scope and frequency of the communications. Another firm suggested that QC 1000 does not need to specifically address certain communications to other participants where this is required by another standard, specifically AS 2101 (as in effect for audits of fiscal years ending on or after December 15, 2024) paragraph .06D, which includes a "written description of all relationships between the other auditor and the audit client of persons in financial oversight roles at the audit client that may reasonably be thought to bear on independence. Another firm commented that the goal of alerting others performing work on behalf of the firm to specific engagement independence requirements could be achieved through engagement-specific independence certifications.

²²¹ See SECPS § 1000.46 (requirement 5).

After consideration of the comments received, we have amended the standard to require at least monthly communication of additions to the list of restricted entities to firm personnel and others performing work on behalf of the firm whose relationships and arrangements with such additional restricted entities may reasonably be thought to bear on the independence of the firm. We believe that it is appropriate to limit communications of additions to the list of restricted entities to firm personnel and others performing work on behalf of the firm to those additions that could reasonably be thought to bear on the independence of the firm. For example, additions to the affiliate list for an issuer would be relevant for an individual who is performing work on behalf of the firm on that issuer, or a partner who is located in the same office of the firm in which the lead audit engagement partner primarily practices in connection with the audit. This communication should be made as frequently as necessary, and on an at least monthly basis, through the period that the individual is subject to the independence requirements.

Several firms and a firm-related group commented that the requirement to communicate the restricted entity list would not be more effective than the automated systems already in place at larger firms. Two firms also commented that smaller firms with infrequent changes to the restricted entity list may not need to communicate changes monthly. One of these firms suggested that many firms already have policies where individuals are required to review the restricted entities list prior to purchasing stock/during proposal/acceptance procedures to determine whether an independence conflict would exist, and that many firms also make those restricted lists readily available to employees as part of their current QC systems. We believe, and have observed through our oversight activities, that such automated systems may not fully mitigate quality risks associated with the timely reporting of financial relationships by firm personnel, for example, if the automated system is not equipped to identify certain financial relationships, or if the firm is reliant on its professionals making timely reporting of these relationships into the firm systems. We believe that requiring the communication of additions to the list of restricted entities to firm personnel whose relationships and arrangements with such additional restricted entities may reasonably be thought to bear on the independence of the firm on an at least monthly basis may prompt firm personnel to report a previously unreported relationship. If there are no additions, there is no required communication.

One firm commented that it is unclear whether communication is intended to mean a distributed communication (e.g., email of the updated list) or communication can be made available (e.g., a website that hosts such list and is readily available to access). Some firms may decide to communicate updates to the list of restricted entities on a more frequent basis, as changes are being made, or in more targeted ways (such as to particular offices or engagement teams). The 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 additions to the list of restricted entities to all firm personnel weekly via e-mail. These firms could continue that practice to comply with the standard. However, other methods

that result in an effective communication may also be acceptable; for example, a firm might communicate that there have been additions to the list of restricted entities via e-mail, and include within the e-mail a link to an accessible website-hosted list of additions.²²² While the standard requires communications of additions to those individuals whose relationships and arrangements with such additional restricted entities may reasonably be thought to bear on the independence of the firm, the firm may choose to extend the communications of additions more broadly. In addition, if the firm communicates additions to less than all firm personnel, then the firm must have correctly identified the group of people whose relationships and arrangements with such additional restricted entities may reasonably be thought to bear on the independence of the firm.

The standard does not prescribe a specific process for maintaining and making available the list of restricted entities to firm personnel and other individuals. Firms are able to determine the specific methods and tools needed to keep the list of restricted entities up to date and to ensure that any additions are communicated on a timely basis to firm personnel and other individuals. This determination is 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 list of restricted entities 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 list of restricted entities. The firm is required to notify relevant professionals of additions to the list at least monthly.

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 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 standard requires each firm to establish its own quality objective, which places responsibility on the firm with respect to resources or services provided by the network or a third-party provider.²²³

²²² Firms are required to communicate additions to the list of restricted entities. For periods where there were no additions, no such communication would be required.

²²³ 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.

We incorporated into QC 1000 the existing SECPS requirements for firm personnel²²⁴ to review the list of restricted entities prior to obtaining any security or other financial interest in an entity, but with the following refinements:

- Require firm personnel to review the list of restricted entities, not only before they or their relevant family members²²⁵ obtain a direct or material indirect financial interest in an entity or enter into a direct or material indirect relationship with an entity,²²⁶ but also after additions 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., going into a chain of command or other covered person role²²⁷), and prior to entering into or modifying any business or employment relationships.
- Require the firm and firm personnel to take required actions on a timely basis if the review of the list of restricted entities indicates that action is required under applicable professional and legal requirements or the firm's policies and procedures.

Under this approach, the firm's policies and procedures will require that the list of restricted entities 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 serves the same purpose as review of the list of restricted entities by firm personnel and helps the firm to identify relationships that may result in noncompliance with applicable professional or legal requirements.

One firm commented that, rather than 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, firms should be permitted to develop quality responses to identify prohibited relationships and fee arrangements that appropriately respond to quality risks, based on the firm's facts and circumstances. The firm also suggested that the requirement for firm personnel to review the list of restricted entities after changes to the list are made should be deleted since firm

²²⁴ SECPS requirements use the term "professionals," which means professional staff, including partners. *See* SECPS § 1000.46 (requirement 1.a).

²²⁵ 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).

²²⁶ We are using the terms direct and material indirect in the same sense as Regulation S-X Rule 2-01(c), 17 C.F.R. § 210.2-01(c).

²²⁷ "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).

personnel would already be notified of changes based on paragraph .34b. We believe these specified quality responses are appropriate and should be addressed by all firms, regardless of the specific facts and circumstances of the firm. In addition, we view the requirements of paragraph .34b. for the firm to maintain and make available the list of restricted entities, and paragraph .34d. for firm personnel to review the list of restricted entities, as separate.

2) Independence and ethics certifications

- e. Obtaining certifications from *firm personnel* regarding familiarity and compliance with (1) SEC and PCAOB independence requirements, applicable ethics requirements, and the firm's independence and ethics policies and procedures upon employment and at least annually thereafter, and (2) SEC and PCAOB independence requirements and the firm's independence policies and procedures upon any change in professional circumstances 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 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.²²⁸

The proposal contemplated 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 firm role, geographic location, or marital status, that is relevant to independence.

Several commenters, including firms, did not support the requirement to obtain additional certifications upon changes in personal circumstances, and three firms raised practical concerns when the changes involved marital status. One firm suggested that the standard should emphasize that a firm's independence certification process should consider timeliness in addressing the quality objective, and instead encourage firms to consider the appropriateness of obtaining periodic certifications throughout the year. One firm commented that a firm should have flexibility to determine its own policies and procedures for certifications

²²⁸ See SECPS § 1000.46 (requirement 7.b).

beyond requiring them at employment and annually thereafter; the firm suggested that, for example, quarterly certification accompanied by training on the impact of life events may be more effective and practicable than event-driven review and certification. Another firm recommended that firms be allowed to develop their own quality responses based on their own unique quality risks when personal circumstances change rather than requiring certification upon changes in personal circumstances as a quality response. Another firm suggested that this requirement should instead be managed through proper education and awareness of relevant independence requirements. Another firm suggested that these items would be better suited as examples of considerations included in implementation guidance. One firm suggested that the certification requirements should be applicable for firms with over 500 issuers that already have an automated independence system. The firm further commented that the requirement is onerous in terms of being able to identify the data on a timely basis and suggested a semi-annual representation period instead of circumstance-driven.

In addition, the proposing release sought feedback on whether the standard should require annual written certification regarding familiarity and compliance with ethics requirements and the firm's ethics policies and procedures, in addition to those regarding independence. The proposing release further asked whether firms should be required or encouraged to adopt firm-wide codes of ethics or similar protocols. One firm did not support a specific quality response that includes a certification process for ethics requirements and procedures. The firm suggested that firms should be permitted to adopt a quality response that addresses the risks within their own practice, and that a certification requirement that applies to all firm practice staff could turn into a "check-the-box" compliance exercise that would not benefit audit quality. One firm commented that such requirements would already be addressed by the requirement for mandatory training in paragraph .36. Other commenters, including firms, investors, and investor-related organizations, supported the requirement to obtain a written annual certification regarding familiarity and compliance with ethics requirements and the firm's ethics policies and procedures. One of these investors commented that the main argument against such certifications is that it imposes a cost and that it becomes a "tick-the-box exercise," but in the investor's view the cost is de minimis given other annual declarations needed by firm personnel, and firm leadership can send an appropriate signal by embracing the ethics code to stop such annual declarations becoming a perfunctory exercise. One firm and an investor-related organization supported a requirement that firms should adopt firm-wide codes of ethics.

After consideration of the comments received, we have made two changes to the final standard. First, we have removed from the standard the requirement to obtain a certification from firm personnel regarding familiarity and compliance with SEC and PCAOB independence requirements and the firm's independence policies and procedures upon any change in personal circumstances, and replaced this with the requirement that such a certification must be obtained for any change in professional circumstances that is relevant to independence. Rather than include examples of such changes in the text of the standard, we have provided in

this release some examples of changed professional circumstances that may be relevant to the independence of the firm's personnel under applicable independence rules. These examples include changes within the firm such as promotions, moving offices, or changing practice groups (e.g., changes to covered person status). Although, in connection with this change, we have removed a certification requirement with regard to changes in personal circumstances, such changes can have independence implications under SEC and PCAOB independence requirements, and a firm's QC system must provide reasonable assurance of compliance with those requirements. Secondly, we added a requirement for certification by firm personnel regarding familiarity and compliance with the applicable ethics requirements and the firm's ethics policies and procedures as we believe such certification will enhance individual accountability and, ultimately, compliance. We have not added a requirement for firms to adopt a firm-wide code of ethics or similar protocol, because we believe that firms should have flexibility to determine whether this would assist them in meeting the relevant quality objectives.

The standard does 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 standard. In addition, the standard expands on the existing SECPS requirement by requiring firms to obtain certifications every time firm personnel have a change in professional circumstances that is relevant to independence, such as a change in role or geographic location. 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. We continue to believe that a specified quality response requiring specific event-driven independence and ethics certifications appropriately considers timeliness in addressing the quality objective and applies to quality risks that exist in all firms.

3) Matters requiring audit committee pre-approval

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

The proposed requirement did not draw comment and has been adopted as 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.

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

The proposed requirement did not draw comment and has been adopted as proposed.

The final standard incorporates existing SECPS requirements regarding the dissemination of the firm's independence policies and procedures and expands the requirements to cover ethics policies and procedures.

When deciding how to make ethics and independence policies and procedures available, firms would consider 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 standard requires 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 requirement did not draw comment and has been adopted as proposed.

The standard includes a requirement for mandatory periodic training on ethics and independence, which expands on the existing SECPS requirements that cover training on independence. The mandatory training requirement promotes 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.²²⁹

The specific content and extent and timing of the training will be determined by the firm, but the program is 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 standard allows 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 independence findings across the firm, or it may target specific ethics and independence findings in different regions. Similarly, the 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 standard, the firm is 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.²³⁰ The SECPS member requirements regarding independence quality controls apply only to certain firms. The 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.

G. Acceptance and Continuance of Engagements

This component addresses the firm's processes when considering whether to accept or continue an engagement.

²²⁹ See SECPS § 1000.46 (requirement 3).

²³⁰ See QC 20.09.

1. QC 1000

.37 This component addresses the firm’s processes for making decisions about whether to accept or continue an *engagement*.

a. Acceptance and continuance of engagements quality objectives

The proposal described the quality objectives related to acceptance and continuance of engagements. Several commenters, including firms, were generally supportive of the proposed quality objectives.

A commenter on the AS 1000 rulemaking objected to the use of the term “client” in that standard to refer to the company and its management. The commenter suggested “company under audit” instead. We agree with the commenter that the terminology used in our standards should help to remind auditors that they work for the benefit of investors, not the management of the company. Accordingly, we have generally replaced references to the “client” with references to the “company” or have eliminated them altogether (for example, this component, called “Acceptance and Continuance of Client Relationships and Specific Engagements” in proposed QC 1000, is “Acceptance and Continuance of Engagements” in the final standard). We have, however, retained references to the “client” where that aligns with other rules, such as in the area of independence.

The quality objectives in this component are adopted substantially in the form proposed, with the exception of the change throughout to focus on the engagement instead of the client relationship and the other clarifications discussed below.

.38 The *quality objectives* established by the firm with respect to the acceptance and continuance of *engagements* should include the following:

- a. Judgments about whether to accept or continue an *engagement* are:
 - (1) Initially 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 company information to perform the *engagement*, including to company 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 company (including management and the audit committee).

Acceptance and continuance of engagements is an aspect of a firm's compliance and risk management process. Each firm, depending on its nature and circumstances, may approach acceptance and continuance of engagements differently. The acceptance and continuance of engagements process assists the firm in mitigating reputational, business, and litigation risk. The quality objectives stress the importance of focusing the acceptance and continuance of engagements process on the firm's ability to perform an engagement in accordance with applicable professional and legal requirements.

i. Timing

The proposed standard required the firm's judgment about whether to accept or continue an engagement to 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 AS 2101.06.

One commenter stated that the proposed requirement implied that the judgment was only made during preliminary activities and not throughout the engagement. We have clarified the quality objective in paragraph .38a.(1) to specify that the initial judgment is to be made as part of or before preliminary engagement activities. QC 1000.40, discussed below, addresses the firm's obligation to continue to address situations that could have caused it to decline the engagement had the information been known prior to acceptance and continuance.

ii. Independence and permissibility of services

This proposed quality objective did not draw significant comment and is adopted as proposed.

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

acceptance and continuance, because in general, under PCAOB standards the firm is not allowed to accept an engagement unless it is independent of the company for which the engagement will be performed 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 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 company information and company personnel

This proposed quality objective did not draw significant comment and is adopted substantially as proposed.

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 company and gain access to individuals at the company who can respond to the firm's inquiries. Restricted or limited access to company 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. We believe 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 includes 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 company) 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 implementation and effectiveness of automated processes; and
- Intellectual resources needed in the performance of the engagement (e.g., industry-specific audit programs).

One commenter suggested that consideration should be given to the availability of industry-specific resources at the partner and manager level and we agree that industry-specific resources are important in certain audits. However, we believe that issue is adequately addressed by the general reference to “resources to perform the engagement,” which includes industry-specific resources where those would be needed. We are adopting this quality objective as proposed.

v. Other relevant factors

This proposed quality objective did not draw comment and is adopted as proposed.

The firm’s ability to perform engagements in accordance with applicable professional and legal requirements may also be affected by other factors associated with providing professional services in the particular circumstances. Accordingly, the 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.

vi. Information about the nature and circumstances of the engagement, including the integrity and ethical values of the company

In order for the firm to make appropriate judgments about whether to accept or continue an engagement, the firm needs to obtain sufficient information about the nature and circumstances of the engagement (e.g., the nature of the company and the environment in which it operates) and the integrity and ethical values of the company, including its management and audit committee.²³¹ 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 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

²³¹ 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*.

help the firm in consistently making appropriate judgments about whether to accept or continue an engagement. 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.²³²

One commenter requested clarification of whose integrity and ethical values are relevant to the consideration of "the integrity and ethical values of the company (including management and the audit committee)" – for example, whether consideration could be limited to the audit committee chair. Since members of management and the audit committee all have influence over the company's financial reporting, we believe their integrity and ethical values are important to the judgment of accepting or continuing an engagement. Therefore, consistent with the proposal, the final standard does not include such a limitation.

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 company.

This quality objective retains the concept in QC 20.16 of having policies and procedures regarding obtaining an understanding with the company about the engagement and aligns with similar requirements under our auditing and attestation standards.²³³ 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 engagements specified quality response

The proposal included 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. Two commenters were generally supportive of the proposed specified quality response.

.39 In designing and implementing *quality responses* to address the *quality risks* in the acceptance and continuance of *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.

²³² See, e.g., AS 2110.41-.45.

²³³ See paragraph .05 of AS 1301, *Communications with Audit Committees*, and paragraph .46 of AT Section 101, *Attest Engagements*.

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 design, implement, and maintain policies and procedures to address situations in which the firm becomes aware of information subsequent to accepting or continuing an *engagement* that could have caused the firm to decline such *engagement* had that information been known prior to acceptance or continuance.

Under this specified quality response, the firm's policies and procedures are required to address situations in which the firm becomes aware of relevant contrary information after the firm's decision to accept or continue an engagement. This contrary information may have existed at the time of the decision to accept or continue an 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 engagement;
- Discussing the information with management and the audit committee to determine if the firm is able to continue the engagement;
- 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.

One commenter suggested that specific circumstances should require an immediate reconsideration of client continuance, such as illegal acts, fraud, or material omissions of fact. Existing auditing standards, such as AS 1301, include requirements related to evaluating the continuation of the client relationship. The QC system would address compliance with these requirements.

Under the proposal, a firm would be deemed to have become "aware" of information if any partner, shareholder, member, or other principal of the firm was aware of such information, the same standard that applies with respect to the reporting of specified events on Form 3. One commenter stated that the concept of when a firm becomes "aware" should take into account the size and scale of the firm, and the nature of the matters related to the QC system, suggesting that alignment with the requirements of Form 3 may be inappropriate because of Form 3's relatively limited scope compared to the matters addressed by QC 1000. We continue to believe that it would be inappropriate to differentiate among firm principals in

this regard; all firm principals should be responsible for promptly communicating and acting upon relevant information. Accordingly, we did not narrow the class of persons whose awareness is attributed to the firm.

Another commenter recommended clarifying the timing of when a firm becomes “aware” of information subsequent to accepting or continuing a client relationship. Footnote 26 of the final standard reflects the suggested clarification that the firm is deemed “aware” of information when any partner, shareholder, member, or other principal of the firm “first becomes aware” of such information.²³⁴

2. Current PCAOB standards

The quality objectives of QC 1000 paragraph .38 do not fundamentally change a firm’s existing responsibilities regarding acceptance and continuance decisions under QC 20.²³⁵ The quality objectives 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.

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. 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, and documenting the engagement; conducting an engagement quality review; and making communications regarding the engagement.²³⁶ In order for the firm to consistently deliver compliant engagements, including when performing work on other firms’ engagements, firm personnel and other participants need to understand and fulfill their responsibilities in accordance with applicable professional and legal requirements.

²³⁴ 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.

²³⁵ *See* QC 20.14-.16.

²³⁶ *See* QC 20.18.

1. 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*.

The proposal described the quality objectives for the engagement performance component and asked if there should be any specified quality responses for this component. Firms that commented were generally supportive of the proposed quality objectives. Two commenters wanted clarity on why some concepts in auditing standards were or were not included in QC 1000. One of these commenters, an investor-related group, suggested the standard address certain areas like fraud protection, crypto assets, climate change, and critical audit matters. We believe these areas are engagement-level specific, whereas QC 1000 focuses on the firm-level controls over engagement responsibilities. Commenters, including firms and related groups, were also supportive of not providing specified quality responses in this component. We are adopting these provisions substantially as proposed.

Under QC 1000, a firm is 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
- (3) Responsibilities for reporting and other communications with respect to the *engagement*.

This proposed quality objective did not draw comment and is adopted as proposed.

The standard uses the term “engagement partner” with its existing meaning under our audit and attestation standards: the member of the engagement team²³⁷ with primary responsibility for the audit, examination, or review, as the case may be.²³⁸ The definition of “engagement” under QC 1000, under which substantial role work is defined as an engagement, does not change the meaning of engagement partner or affect the responsibilities of individuals involved in substantial role engagements. We did not receive any comment on the use of this term.

i. Responsibilities of the engagement partner

The engagement partner is responsible for the engagement and its performance, including managing and achieving consistent compliance with applicable professional and legal requirements on the engagement. This quality objective focuses firms on partner involvement throughout the engagement, including appropriately supervising firm personnel and other participants.²³⁹

ii. Due professional care

Due professional care means acting with reasonable care and diligence, exercising professional skepticism, acting with integrity, and complying with applicable professional and

²³⁷ The term “engagement team” is used as defined in the amendments to AS 2101, *Audit Planning*, adopted in PCAOB Rel. No. 2022-002, which takes effect for audits of financial statements for fiscal years ending on or after December 15, 2024.

²³⁸ See AS 1201.A2; AT No. 1 at paragraph 7 note; AT No. 2 at paragraph 6 note. AT 101 uses the term “practitioner with final responsibility for the engagement,” which we construe as having the same meaning.

²³⁹ See generally, e.g., AS 1201.

legal requirements.²⁴⁰ In the context of engagement performance, professional skepticism is an attitude that includes a questioning mind and critical assessment of audit evidence and other information that is obtained to comply with PCAOB standards and rules. 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.²⁴¹ As an 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 quality objective related to due professional care, including professional skepticism, enables appropriate conclusions to be reached that are supported by sufficient appropriate evidence.²⁴²

iii. Supervision

Proper supervision aims to ensure that work is performed as directed and supports the conclusions reached.²⁴³ The 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.²⁴⁴ 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.

²⁴⁰ The general principles and responsibilities of the auditor when conducting an audit, including professional skepticism and due professional care, are being reaffirmed and combined in AS 1000, as adopted. *See Auditor Responsibilities Release.*

²⁴¹ *See, e.g., 2022 Broker-Dealer Inspection Report, at 31.*

²⁴² *See Section IV.C.1.a.*

²⁴³ *See AS 1201.02.*

²⁴⁴ *See generally, e.g., AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; AS 2201.85-.89; AS 1301; paragraphs 34-38 of AT No. 1; and AT 101.63-.90.*

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 or addressed as a difference in professional judgment in accordance with paragraph .42c;
 - (2) In accordance with *applicable professional and legal requirements*; and
 - (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 quality objective should drive firms to continue to focus on the importance of consultation and resolution before the issuance of an engagement report.

The quality objective in the proposed standard provided that consultations on complex, unusual, or unfamiliar accounting and auditing matters are undertaken with qualified individuals from within or outside the firm.

One commenter suggested that the standard require firms to adopt policies that identify situations when national office consultation is required. We do not believe it is appropriate to include such prescriptiveness in the standard, as not all firms have national offices. Additionally, the quality objective provides that the firm will identify the risks specific to their engagements and determine whether there are specific situations that always require consultation.

Another commenter said that the reference to “unfamiliar” accounting and auditing matters was unclear and was concerned that it creates an unnecessary level of prescription that

will be difficult to operationalize. The commenter also expressed concern that an unintended consequence could be that auditors may infer that consultations may compensate for lack of competence on the engagement team. The final standard retains the term, consistent with the use of “unfamiliar” in current QC 20.19. We note that inclusion of that term in paragraph .42 does not modify or limit auditor obligations to have the competence necessary to conduct the engagement established elsewhere in our standards.

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 quality objective underscores 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.

The proposed quality objective provided that differences in professional judgment related to the engagement 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. One commenter suggested clarifying that if the engagement partner does not agree with the conclusions arising from the consultation (addressed above), that would be treated as a difference in professional judgment that would require compliance with the quality objective regarding differences of professional judgment. The final standard clarifies that point.

c. Engagement documentation

d. *Engagement* documentation is prepared, reviewed, assembled, and retained in accordance with *applicable professional and legal requirements*.

This proposed quality objective did not draw significant comment and is adopted as proposed.

AS 1215 contains the general requirements for the documentation the auditor should prepare and retain in connection with engagements. Regulation S-X Rule 2-06 also addresses documentation retention requirements.²⁴⁵ The quality objective regarding engagement documentation in proposed QC 1000 is meant to drive firms to focus on compliance with these requirements.

²⁴⁵ 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 of policies and procedures by their associated international firms or network regarding filing reviews, inspection procedures, and disagreements between the engagement partner and the reviewer.²⁴⁶ As noted in the proposal, we believe that the purposes originally intended to be served by Appendix K have either been eliminated (through the elimination of the U.S. GAAP reconciliation) or otherwise addressed (through requirements for engagement quality review). Accordingly, we proposed to not retain requirements like those in Appendix K.

The proposal asked whether we should eliminate Appendix K and rely exclusively on a risk-based approach. Commenters had mixed views regarding the retention of Appendix K requirements. Some commenters supported the elimination of Appendix K requirements and reliance on a risk-based approach. Other commenters asserted that the Appendix K requirements are beneficial and should be retained or made even more prescriptive. We believe it unnecessary to retain the Appendix K requirements because under the risk-based approach, firms will have to assess and respond to quality risks including, if applicable, a relative lack of experience in performing engagements under U.S. professional and legal requirements.

Some commenters expressed concern that in a risk-based approach, a person performing a limited review function similar to the current Appendix K reviewer would be considered part of the engagement team, while another commenter requested clarification that such a reviewer would not necessarily be a member of the engagement team. Under QC 1000, the firm's assessment of quality risks will determine the nature and extent, if any, of additional resources or reviews that would need to be performed over engagements to ensure compliance with PCAOB and SEC requirements. In some circumstances, the response might involve adding one or more additional members to the engagement team. In other circumstances, the response might involve resources that would not constitute members of the engagement team because they perform a contemporaneous quality control function and do not perform audit procedures or help plan or supervise the audit work.²⁴⁷

One commenter expressed concern that reviewers' firms would be considered "other accounting firms" and reviewers' hours would be included for purposes of Form AP filings.

²⁴⁶ 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.

²⁴⁷ See PCAOB Rel. No. 2022-002 at A4-5.

Specific to Form AP filing requirements, firms should review the Note to Item 3.2 of the Form AP Instructions regarding the reporting of other accounting firms.²⁴⁸

3. Current PCAOB standards

Under current QC standards, engagement performance covers all phases of the design and execution of the engagement, and engagement quality reviews.²⁴⁹ 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. QC 1000 retains these concepts from the extant standards.

As discussed above, QC 1000 does not contain provisions similar to the Appendix K requirements that currently apply to former SECPS member firms.

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. 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

The proposal asked if our proposed quality objectives for resources were appropriate. Commenters that responded to this question generally supported the quality objectives. One commenter suggested that the risks associated with the resources component are greater and that a prescriptive approach would be warranted. We believe the combination of quality

²⁴⁸ See *id.* at A3-19.

²⁴⁹ See QC 20.18.

objectives and specified quality responses appropriately provides for scalability and prescriptiveness.

Under QC 1000, a firm is required to establish quality objectives for the resources component in several different areas:

- People;
- 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. Competence is measured both qualitatively and quantitatively.

- 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, and we are adopting them as proposed with one change. The proposed standard included a note that describes what competence comprises—knowledge, skill, and ability—which is derived from QC 40.04.²⁵⁰ Two commenters suggested deleting the last sentence in the note, which as proposed stated that “The measure of

²⁵⁰ 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 in any given time period).

competence is qualitative rather than quantitative...,” on the basis that it would discourage the use of quantitative performance metrics. We believe that QC 40 should be understood as saying, not that quantitative measures are wholly irrelevant, but that competence is not measured exclusively on a quantitative basis because quantitative measurement alone may not accurately reflect the nature of experience gained over time. We revised the note in the final standard to clarify that competence can be measured both qualitatively and quantitatively.

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 education, professional experience in accounting and auditing with proper supervision, 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.

- c. *Firm personnel* and individuals who are *other participants* assigned to *engagements*, including the engagement partner and engagement quality reviewer, have the competence, objectivity, and time needed 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. *Firm personnel* and individuals who are *other participants* assigned to perform activities within the QC system have the competence, objectivity, authority, and

time needed 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 firm personnel and individuals who are other participants, in the firm's engagements, QC roles, and other firms' engagements. As discussed in Section III.B, the firm's people resources may include firm personnel (generally, employees of the firm) or resources 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 functioning as firm employees) or other participants (if contracted by the firm).²⁵¹ One commenter was concerned that the inclusion of other participants in the firm's QC system may create cross-jurisdictional legal issues, such as employment information that may be protected by privacy laws. We believe it is important for the QC system to assess the competence of other participants, which may include having policies and procedures on what to do if the firm is unable to make such assessment due to legal issues. One commenter mentioned that the responsibilities related to the use of specialists engaged by the firm, other auditors, and internal auditors providing direct assistance are addressed in existing auditing standards as engagement team responsibilities and are not needed within this quality objective. While we acknowledge there are auditing standards that address those topics at the engagement level, the quality objectives relate to the firm's processes for assigning the appropriate individuals to engagements and QC activities.

One commenter emphasized the need for firm resources to have time to fulfill their assigned responsibilities. Another commenter suggested a prescriptive approach to human capital management, including monitoring assignments and time requirements, utilization, and engagements with high turnover and workloads. Given the wide range of firms based on their size, scope, and nature of practice, we do not believe prescriptive requirements in this area are appropriate. We have clarified paragraphs .44c and .44e by adding "needed" to the quality objective to increase the focus on sufficient competency, objectivity, time, and when appropriate, the authority needed to fulfill their assigned responsibilities. We have also separately proposed new reporting requirements regarding firm and engagement metrics that, if adopted by the Board and approved by the SEC, would enhance transparency about, among other things, firms' human capital management.²⁵²

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

²⁵¹ See QC 1000.A5 and .A7.

²⁵² See PCAOB Rel. No. 2024-002.

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.

In addition to the competence, objectivity, and time needed to perform 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 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*.

The quality objective to comply with the firm's policies and procedures did not attract comment and is adopted as proposed.

This 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 important role in the operation of the QC system under 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, including through compensation plans and decisions in which quality considerations play a critical part, 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. Some commenters, generally investor-related groups, suggested the

standard address incentives in partner compensation relative to quality control systems and weight it at least as much as revenue growth. After considering comments, we revised paragraph .44g to add “including through compensation plans and decisions in which quality considerations play a critical part.” We believe this change will prompt firms to appropriately weight quality concerns in their organization-wide compensation plans and individual compensation decisions. We believe this change, along with the change to the quality objective in paragraph .25b, should result in firms giving appropriate weight to quality in compensation plans and decisions regarding performance for both firm leadership and firm personnel.

The quality objective contemplates that evaluations should be performed at least annually. Many firms currently utilize an annual performance review process in order to facilitate such evaluations. A firm may have multiple quality responses to address the quality risks associated with the different types of firm personnel. For example, non-employee contractors and consultants, who work under the firm’s supervision or direction and control and are considered firm personnel, may be evaluated through the contracting process to determine whether the firm should retain them. The quality objective does not specify the format of or approach to periodic evaluations.

The quality objective in QC 1000, which refers to accountability and incentives, is principles-based, and firms will be able to design and implement incentive systems based upon their nature and circumstances. The “appropriate standards of conduct” identified in the quality objective 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 standard.

ii. Technological resources

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.

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.

This quality 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 proposal asked if the quality objective and specified quality responses related to technological resources provide sufficient direction to enable the appropriate use of emerging technologies. Commenters that addressed this question, generally firms, indicated the proposed quality objectives and specified quality responses provide sufficient direction. One commenter suggested that the standard does not create incentives to use technology to improve audit quality.

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 are more adaptable to future developments, less likely to become obsolete, and less likely to discourage the use of emerging technologies. As a result, QC 1000 does not include any prescriptive requirements 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.²⁵³ Separately, the Board has proposed certain amendments to PCAOB auditing standards that address certain aspects of designing and performing audit procedures using technology-assisted data analysis of information in electronic format.²⁵⁴

We are adopting the technological resources quality objective as proposed. We believe the risk-based approach creates incentives for firms to obtain or develop, implement, maintain, and use technological resources throughout the firm based on the size and nature of the firm.

²⁵³ See paragraph .20a.(1)(e) and Appendix B paragraph .B6 of QC 1000.

²⁵⁴ See *Proposed Amendments Related to Aspects of Designing and Performing Audit Procedures that Involve Technology-Assisted Analysis of Information in Electronic Form*, PCAOB Rel. No. 2023-004 (June 26, 2023).

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, to enable the operation of the firm's QC system and the performance of its *engagements*, including, for example, the firm's policies and procedures, methodologies, guides, practice aids, and standardized documentation templates.

The quality objective related to intellectual resources did not attract comment and is adopted substantially as proposed. We revised the note to add "to enable the operation of the firm's QC system," consistent with the quality objective.

Intellectual resources generally include the information the firm uses to promote consistency in the execution of the firm's QC system and the performance of engagements. Intellectual resources may be made available through a variety of media, including via written manuals or technological resources (e.g., the firm's methodology may be embedded in the information technology application that enables the operation of the firm's QC system and facilitates the 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 is responsible for choosing a 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 a methodology to direct the performance of its engagements in accordance with applicable professional and legal requirements, and a new auditing standard was issued after that methodology was implemented by the firm, the methodology would need to be updated to properly address the applicable professional and legal requirements.

The quality objective related to intellectual resources in the final standard 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.

The proposal included a quality objective related to the resources provided by a network or a third-party provider. One commenter requested the objective be broken into two quality objectives, as a firm's approach to each of these groups may be significantly different. We agree that a firm's approach to resources provided by the network may be different from resources provided by a third-party provider, and that the approach to different types of third-party providers could also vary. But we do not believe that such differences compel separate quality objectives. A firm may identify multiple quality risks and develop multiple quality responses related to a single quality objective.

For example, a firm may use multiple third-party providers for a variety of different resources, such as an audit methodology provider or a confirmation intermediary. If these different types of third-party providers or resources present different risks, the firm would be required to develop different quality responses. In that scenario, the firm could have different policies and procedures applicable to different types of third-party providers and/or different types of resources. A firm that is not affiliated with a network is not required to establish a quality objective related to network-provided resources and therefore would not identify quality risks or related quality responses.

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 its 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 will 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 remains 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 is also 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.

The proposal asked if the specified quality responses for resources were appropriate. Two commenters that addressed this question supported the specified quality responses. Two other commenters objected that the specified quality responses were too prescriptive and suggested they be rewritten as risk-based quality objectives.

One commenter stated that certain of these requirements relate closely to auditing standards and requested clarity on how QC 1000 is intended to interact with engagement-related auditing standards. QC 1000 focuses on firm-level controls over compliance with auditing standards, including those related to engagement performance.

We are adopting the specified quality responses as proposed, with one modification suggested by commenters. These specified quality responses carry provisions from our existing QC standards into QC 1000, or establish firm-level requirements that align with existing

engagement-level requirements. They also include new requirements that we believe are important to a firm's QC system.

.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 specified quality response related to appropriate standards of conduct did not attract comment and is adopted as proposed.

The reference to "appropriate standards of conduct" reflects a number of concepts in existing PCAOB standards, including:

- Fulfilling responsibilities with professional competence;²⁵⁵
- Integrity and objectivity;²⁵⁶
- Due professional care (including the exercise of professional skepticism);²⁵⁷ and
- Complying with applicable professional and legal requirements and the firm's policies and procedures.²⁵⁸

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. We believe the standards of

²⁵⁵ See, e.g., QC 20.13a, .13b, and .15a.

²⁵⁶ See, e.g., QC 20.10.

²⁵⁷ The general principles and responsibilities of the auditor when conducting an audit, including professional skepticism and due professional care, are being reaffirmed and combined in AS 1000, as adopted. See Auditor Responsibilities Release.

²⁵⁸ See, e.g., QC 20.03.

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, other *firm personnel* 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*;
 - d. For attestation *engagements*, the subject matter of the assertion on which the *engagement* is based;
 - e. The industry in which the company operates and its relevant characteristics (e.g., applicable standards, industry-specific risks, and industry-specific estimates);
 - f. The internal control framework used by the company;
 - g. The use of technology by the company 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.²⁵⁹ The proposed standard required that firms’ QC policies and procedures address certain enumerated competencies, as well as other competencies as necessary in the circumstances. Some commenters suggested that the competencies identified in proposed paragraph .47a-h be moved to a quality objective or staff guidance, and argued that they were redundant to the auditing standards. We believe that the competencies in paragraph .47 are applicable to all firms and accordingly are appropriate as specified quality responses. One commenter asked for clarification of the expectation of “including an

²⁵⁹ See, e.g., QC 40.08; AS 1220.05.

understanding of” and suggested that the standard include consideration of “other competencies as necessary in the circumstances,” consistent with QC 40.08. We believe that auditors should be familiar with the concept of obtaining an understanding, and note that the construct of QC 40 is a restrictive list whereas the list of competencies in this requirement is identified as “including” and not intended to be comprehensive, so we do not believe a reference to other competencies is necessary.

One commenter indicated that the firm would not be in a position to impose the specific requirements in paragraph .47 on individuals that are not part of the firm. We have narrowed the requirement to apply only to firm personnel, rather than “others participating in an engagement,” as proposed. We note, however, that other quality objectives, such as those in paragraphs .44c and .44e, continue to apply with respect to individuals outside of the firm as well as firm personnel. As discussed in more detail in Section IV.G, Acceptance and Continuance of Engagements, we have also revised “client” to “company” in paragraph .47.

Paragraph .47 of QC 1000 both expands the required competencies for engagement partners and requires certain competencies for other firm personnel 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 company 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 requiring competencies related to understanding the subject matter of attestation engagements, the internal control framework and technology used by the company, and the technological and intellectual resources used in performing engagement procedures. Regarding technological and intellectual resources, we require an understanding of how and whether it is appropriate to use these resources in performing the engagement. This specified quality response does not imply that the engagement partner or other firm personnel participating on an engagement need to 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.²⁶⁰ 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.²⁶¹

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.

One commenter requested the standard set out more specific requirements with respect to training, identify areas or categories that must be regularly addressed, and not eliminate the CPE obligation in the existing standard. Another commenter requested the standard include minimum requirements related to training of audit staff. 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. If we were to set specific requirements with respect to training, firms may not evolve their training over time to respond to changes in the firm or in the needs of firm personnel. We are maintaining the principles-based approach to training.

Under the specified quality response in the final standard, the firm is required to provide training, including training on applicable professional and legal requirements, that is mandatory for all firm personnel on an annual basis. This specified quality response provides firms the ability to determine the type and extent of training necessary based on their 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 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 repeat training as a periodic reminder of existing requirements, such as those relating to internal control over financial reporting. Ultimately, the type and extent of training should be directed at whatever is necessary to enable firm personnel to fulfill their assigned QC and

²⁶⁰ See QC 20.13; QC 40.02, .05.

²⁶¹ 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.

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 specified quality response did not attract comment and is adopted as proposed.

This 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, including through compensation plans and performance decisions regarding performance that appropriately prioritize quality considerations, 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.²⁶² A firm will 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.

.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*.

No comments were received on this specified quality response and it is being adopted as proposed.

Laws or regulations may establish requirements for the professional licensing or other qualifications of the firm and firm personnel. Under this specified quality response, the firm is required to have policies and procedures regarding licensure such that the firm and firm

²⁶² Evaluation of a firm's QC system is addressed in paragraphs .77-.78 of QC 1000 and discussed in Section IV.L below.

personnel hold the required licenses or qualifications. The policies and procedures 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 quality objective in paragraph .44h. provides that technological resources are 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. One commenter stated that the quality objective in proposed paragraph .44h is sufficient and this specified quality response should be removed. We believe the firm's policies and procedures should address its technological resources having the capacity (resource requirements for the necessary output), integrity (guarding against improper information modification), resiliency (ability to operate and recover under adverse conditions), availability (ensuring timely and reliable access to and use of information), reliability (ability to function consistently), and security (protection against intentional subversion).²⁶³ These characteristics enable the ongoing operation of the firm's QC system and performance of its engagements. We believe this specified quality response provides additional direction and have retained it in the final standard.

Also related to technology, the proposal asked if the standard should 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 companies for which the firm performs engagements. Several commenters did not support inclusion of such a specified quality response. One commenter requested a requirement to design and implement controls to prevent unauthorized access to data and technology. We did not make any changes or additions to the quality objective or specified quality responses related to technological resources because we believe the more general provisions appropriately address this issue, and more specific provisions are at risk of quickly becoming outdated as technology evolves.

²⁶³ See, National Institute of Standards and Technology Glossary, *available at* <https://csrc.nist.gov/glossary>.

2. Current PCAOB standards

QC 1000 largely covers the same areas addressed in QC 20 and QC 40 for personnel management and assignment of responsibilities.²⁶⁴ Existing PCAOB QC standards do not provide specific direction on the use of intellectual resources or technological resources, except for one application regarding independence.²⁶⁵

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.²⁶⁶ As discussed in more detail below, we have made some changes in response to commenter input but are adopting most provisions as proposed.

1. 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 performance of its *engagements*, and for communicating information within the firm and to external parties on a timely basis.

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.

One firm suggested that the information and communication component refer to "relevant and reliable" information to convey that not all information is intended to be obtained and disseminated to the relevant individuals or roles. The firm disagreed that relevance and reliability is implied within the context of the proposed requirements, and argued that the term "information" needs parameters and qualifying language to provide

²⁶⁴ See QC 20.13 and .22.

²⁶⁵ See SECPS § 1000.46 (requirement 4).

²⁶⁶ Other aspects of the standard also include specific provisions regarding communication (see, e.g., paragraphs 16-.17 in Roles and Responsibilities, and paragraphs .31 and .35 in Ethics and Independence).

boundaries to the vast amount of information that exists or could be created in the context of a firm's QC system. The firm further argued that without appropriate qualifiers, the breadth of information to be considered and/or communicated within a QC system will inhibit firm leaders from identifying and focusing on information most relevant to the successful operation of the QC system. As discussed in the proposal, 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. We continue to believe that information would have to be relevant and reliable to 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, so that a reference in the standard to "relevant and reliable" information is unnecessary.

a. Information and communication quality objectives

The standard requires the firm to establish a number of quality objectives for the information and communication component. These objectives are discussed in more detail below. One firm commented that, as the proposed quality objectives for information and communication are broadly consistent with other jurisdictional and international quality control/management standards, they are appropriate, and no further changes are needed.

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 are able to determine the type of information systems necessary to achieve their quality objectives.

One commenter suggested that the information and communication component could be enriched by explicitly integrating academic audit and accounting studies as a vital source of

information to be used by firms to inform their QC system. We believe that the quality objectives within the information and communication component sufficiently establish the desired outcomes for the identification of external information to support the operation of the firm's QC system. A firm may determine that the conclusions of certain academic studies inform the design or operation of its QC system. Furthermore, depending on the nature and circumstances of the firm and its engagements, the firm may consider any applicable academic studies in the firm's risk assessment process as it obtains an understanding of the conditions, events, and activities that may adversely affect the achievement of its quality objectives. The requirement is adopted as proposed.

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.²⁶⁷ The quality objective prompts 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 company obtained during engagement performance that may assist the firm when evaluating whether to continue the engagement. 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

²⁶⁷ See, e.g., 2019 Inspection Observations Preview at 5.

procedures. The standard emphasizes the need for two-way communication within the firm and the responsibility of all firm personnel to communicate information.

One commenter addressed the quality objectives set out in paragraphs .53b.-.53c. of the proposed standard related to the timely exchange of information between firm personnel and leadership, including those with responsibilities for the firm's QC system. The commenter recommended that the final release clarify that the firm's policies and procedures assist in promoting communication such that the appropriate individuals with responsibilities over the firm's QC system become aware of relevant matters in a timely manner, as appropriate for the size and the scale of the firm and relative nature of the matter. As discussed in Section IV.C.1.e. above, we believe timely communication and action should be sufficiently prompt to achieve its objective and that timeliness is a function of the nature and significance of the issue. These requirements have been adopted as proposed.

iii. External parties

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.

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.

The standard requires 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 (paragraph .53d.) covers 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 Form QC). It would also cover reporting under our proposed revised reporting requirements and metrics requirements²⁶⁸ if those are ultimately adopted by the Board and approved by the SEC.

²⁶⁸

See PCAOB Rel. No. 2024-002.

An investor expressed concern with the absence of references to investors or the public from the examples of external parties, and further commented that the proposal makes no mention of the role of quality control with respect to critical audit matters. This provision relates to communications to external parties that are required under applicable professional and legal requirements. Under current requirements, the only required communication from the audit firm to investors is the audit report. Audit reporting is part of engagement performance, is covered by a separate quality objective relating to engagement performance,²⁶⁹ and is not addressed by this quality objective. To the extent that a communication to a regulator is ultimately available to the public (as is the case with, for example, various forms filed with the PCAOB), such communications would be covered by this quality objective, thus providing downstream benefits for investors and the public.

A firm recommended that the scope of the requirement be limited to information or communications regarding a firm's audit practice and engagements performed in accordance with PCAOB standards. As discussed in more detail in Section III.B.1. above, the definition of applicable professional and legal requirements in the final rule has been more narrowly tailored to address engagements, as defined in QC 1000, and the QC system itself. We believe this change addresses the commenter's concern about the possible overbreadth of the quality objective, and we have adopted it as proposed.

- e. If a firm communicates firm-level or *engagement*-level information with respect to the firm's audit practice, *firm personnel*, or *engagements*, such as firm or *engagement* metrics, to external parties, such information is accurate and not misleading and, with respect to any such metrics that are communicated in writing, the communication explains in reasonable detail how the metrics were determined and, if applicable, how the method of determining them changed since the metrics were last communicated.

We have also observed that some firms make public communications about firm-level or engagement-level information, such as firm 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;

²⁶⁹ See paragraph .42a.(3): "Responsibilities are understood and fulfilled . . . , including, as applicable . . . Responsibilities for reporting and other communications with respect to the engagement."

- 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. Furthermore, if adopted, the Firm and Engagement Metrics proposal will require firms to publicly report certain metrics relating to their audits and their audit practices.

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 and the performance of their engagements. Such information can influence the views of relevant stakeholders, including audit committees determining whether to engage or retain an auditor and investors determining whether to ratify such an appointment.

The proposed standard contemplated that the firm would 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, that the communication 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 view is that a specific quality objective in this area will prompt firms to implement targeted policies and procedures that address, for example, the quality and consistency of data and the need for context or explanation. This in turn will improve the informativeness, reliability, and comparability of such communications and avoid misleading the intended audience.

Several commenters, including firms and related groups, broadly supported the quality objectives or agreed that it is important to address communications to stakeholders about a firm's or engagement's performance, and that such communications should be accurate and not misleading. However, many of the commenters on this topic raised concerns with regard to the proposed quality objective addressing the firm's external communications relating to metrics.

Several commenters suggested that additional clarification be provided on the metrics and communications that are in scope for the quality objective. Some commenters recommended that the scope of the requirement be limited to metrics related to audit quality that are required to be communicated under applicable professional, legal, or other regulatory requirements and are communicated publicly. One firm recommended that the scope of

metrics be limited to those related to the effectiveness of the firm's QC system or audit quality, and that the scope of the communications be limited to "formal" external reporting such as audit quality reports, transparency reports, communications with audit committees, and other published reports. Another firm recommended that the external communications in scope for the objective should be limited to communications externally about audit quality and should not extend to other external information issued by the firm that is not specifically related to audit quality such as marketing communications or recruiting information. The firm further argued that this limitation on scope to only audit-quality-related external communications should also apply to the communication of how metrics were determined and explanations of year-on-year changes. Another firm recommended that the scope be limited to information or communications regarding a firm's audit practice and engagements performed in accordance with PCAOB standards.

One firm expressed concern regarding firms' ability to design and implement quality responses to address the risk of every type and form of information communicated given the broad scope of the requirement. The firm recommended that the scope should be limited to information resulting from and regarding the evaluation of the firm's QC system, which will allow firms to focus efforts on the information that is most meaningful to stakeholders, which in turn will enhance the reliability of such information.

One firm commented that in addition to recommending limiting the quality objective to engagements performed under PCAOB standards that would be subject to the firm's QC system, it may not be practicable to communicate in reasonable detail how a metric was determined in all situations (e.g., if the metric was provided in a speech). The firm asserted that it should be allowed to present the information about how a metric was determined and, if necessary, how it changed, in a single, publicly available location (e.g., on the firm's website). One firm commented that the level of disclosure that would be required may create confusion or may not ultimately be necessary, in particular in instances when the metric does not relate to audit quality. Further, the firm stated that the disclosures may conflict with requirements that may apply to registered firms outside of the U.S. Another firm recommended that the words "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" be removed from the quality objective. The firm asserted that this requirement may discourage smaller firms from including many quality metrics in their audit quality, transparency, and similar reports given limited time and resources available to produce their voluntary report. Some commenters, including firms and a related group, recommended that considerations related to metrics in QC 1000 be taken up as part of the PCAOB's research project on firm and engagement performance metrics.

After consideration of the comments received, we continue to believe it is appropriate that all firm communications to external parties regarding themselves and their audit practice, in whatever medium, meet the minimum standard of being accurate and not misleading.

However, in response to commenters, we have clarified the quality objective in certain respects. We have clarified that the quality objective is limited to communications regarding the firm’s audit practice, firm personnel, or engagements and removed the word “performance” from the phrase “performance metrics,” to align with the terminology use in our proposed metrics requirements.²⁷⁰ Additionally, we have revised the quality objective to provide that only metrics communicated in writing require an explanation of how the metrics were determined and, if applicable, how the method of determining them changed since metrics were last communicated. We believe this will address commenter concerns about the feasibility of providing such explanations for metrics communicated orally. In addition, we have removed the requirement to explain in reasonable detail, if applicable, how the metrics themselves have changed since they were last communicated. We believe that requiring an explanation of how the metrics were determined and, if applicable, how the method of determining the metric changed since it was last communicated will enhance the understandability and comparability of the metrics made available to external parties. However, we do not believe it to be necessary to require narrative discussion of numeric changes in the metric period over period if there has been no change in the underlying calculation method.

These disclosures may be incremental to requirements that could apply to registered firms outside of the U.S., however, we do not believe that these requirements will operate in conflict. We have observed variation and complexities in how metrics are defined and calculated by firms, as well as changes in the calculation method over time such that we believe this quality objective is necessary to improve the informativeness, reliability, and comparability of such communications and avoid misleading the intended audience. In addition, over 100 unique qualitative disclosures and quantitative audit quality metrics have been observed by the Center for Audit Quality (“CAQ”) in its analysis of the CAQ’s eight Governing Board firms’ most recent audit quality reports.²⁷¹ We believe this indicates both a demand for and an ability to supply metrics, which further emphasizes the need for consistency and comparability of the metrics.

We considered whether it would be appropriate to allow for additional disclosures relating to metrics to be presented in a single public location such as the firm’s website. However, we believe that by limiting the requirement to written communications, we have eliminated the concern about how to present such information with respect to an oral communication, and given the importance of the information to the intended audience, that this should be presented in the same written communication as the disclosed metrics.

²⁷⁰ See PCAOB Rel. No. 2024-002.

²⁷¹ See Audit Quality Reports Analysis: A Year in Review, available at <https://www.thecaq.org/aqr-analysis-yir/>.

We received feedback from a number of commenters, including investors and related groups, criticizing the proposal for failing to include required metrics or audit quality indicators. We have proposed a separate standard on firm and engagement metrics²⁷² and we have addressed these comments in that proposal.

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.

We did not receive comment on the proposed quality objective relating to the exchange of information between a firm and a network and are adopting it as proposed.

v. Other participants

Many firms have increasingly involved parties outside the firm in QC functions, such as independence compliance, and engagement functions, such as performing audit procedures and evaluating audit evidence. Working with other participants can differ from working with individuals within the firm. For example, auditor-engaged specialists²⁷³ 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

²⁷² See PCAOB Rel. No. 2024-002.

²⁷³ AS 1210, 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.

participant's work.²⁷⁴ 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 accordance with applicable professional and legal requirements and the firm's policies and procedures.

g. If *other participants* are used in the firm's QC system or *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 the aspects of the QC system and the *engagements* in which they are involved 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.

We have broadened the language of the quality objective to clarify that it applies to the use of other participants in both the firm QC system and in engagements.

For other participants that are firms, we proposed that information obtained from the other participants should include the conclusion of the most recent evaluation of its QC system and a brief overview of remedial actions taken and to be taken, as well as a footnote clarifying that 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 evaluation date, if such an evaluation was performed, and otherwise to the most recent QC evaluation performed by the other participant firm under any professional standard.²⁷⁵

One commenter stated that audit firms monitor the quality of member firms but have typically been reluctant to share negative information about a member firm, and that requiring transparency in such information would be beneficial. However, several firms and related groups expressed concerns about the impact of having other participant firms share the most

²⁷⁴ See, e.g., PCAOB Rel. No. 2022-002.

²⁷⁵ See, e.g., ISQM 1 paragraphs .53-.54; and SQMS 1 paragraphs .54-.55.

recent evaluation of their QC system based on the confidentiality protections set out in Sarbanes-Oxley or other relevant local laws and regulations. Two firms commented that these concerns would be alleviated if the definition of QC deficiency was updated to align with the definition in ISQM 1 and SQMS 1. One firm commented that the proposed quality objective addressing information and communication related to other participants is appropriate, however if information is to be shared at the deficiency level, the firm is concerned that this would violate the confidentiality provision within Sarbanes-Oxley. Another firm suggested limiting the extent of information shared to only what is necessary for firms to achieve the reasonable assurance objective. This firm agreed with obtaining and considering the other participant firm's overall conclusion of the most recent evaluation of the QC system, however it argued that this should not include information regarding deficiencies, if any, and remedial actions taken and to be taken. Some commenters argued that firms should be able to take a risk-based approach in determining whether it is necessary to request specific information regarding an other participant firm's QC system.

One firm-related group argued that certain international legislation may be an issue for firms when reporting clients' or individuals' personal information. The commenter further expressed concerns that those firms applying QC 1000 fully and reporting thereunder may be selected in preference to those using other standards. Another firm-related group expressed concern that a firm-level QC inspection finding might result in the best firm for the component auditor role being bypassed. The commenter further suggested that guidance is needed for when the evaluation and/or overview of remedial actions is not forthcoming.

Some commenters, including firms and a related group, argued practical concerns regarding the application of the requirement to other participants not registered with the PCAOB. One firm commented that, while it is not aware of any legal or regulatory concerns with other participants sharing the most recent evaluation of their QC system, it suggested that the PCAOB state that firms will not violate this requirement if local laws or regulations exist that prevent compliance.

After consideration of the comments received, we have amended the standard to limit the information that should be obtained to only the conclusion of the most recent evaluation of the QC system. We believe that this addresses commenter concerns relating to the risk of communicating privileged information. Furthermore, we continue to believe that obtaining the communication of the conclusion of the other participant's most recent evaluation 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, including ensuring that the best firm for the job is not bypassed. If necessary, the firm may discuss the conclusion with the other participant firm to seek to gain a better understanding of the basis for such conclusion.

We believe that in practically all cases, the firm would be able to obtain the conclusion of the most recent evaluation of the other participant's QC system. However, if a firm is unable to obtain this (for example, if the other participant has not performed an evaluation, or if local laws forbid them from sharing it), then the firm should assess what other procedures are necessary to achieve the quality objective.²⁷⁶

One firm commented that paragraph 53f. specifically addressed networks, while .53g. addresses other participants, and that it was unclear whether paragraph .53g. also applies to networks given their inclusion in the definition of "other participants" or if the Board intends for paragraph .53g. to apply to any other party defined within "other participants." Paragraph .53g. applies to firms within a network to the extent that the firm is an other participant, as defined in QC 1000.A7 and discussed in more detail in Section III.B. above.

Another firm expressed concerns that it may not be able to practically apply paragraph .53g. to all "other participants." Specifically, the firm requested clarification as to the expectation regarding the extent to which firms design policies and procedures to ensure other participants comply with applicable professional and legal requirements, including bifurcation of participants that are part of the engagement team as compared to participants in the firm's quality control system. Another firm suggested it would be impractical to suggest that a firm's QC system can be applied to other participants or that they would explicitly comply with the firm's policies and procedures as if they were part of the firm. As discussed in more detail in Section III.B.4. above, just because a quality objective or other provision of QC 1000 refers to all types of other participants in the same way, this does not mean that the firm should respond by treating all types of other participants in the same way. The firm's policies and procedures addressing other participants should differentiate based on the types and roles of other participants to the extent necessary to be responsive to the firm's quality risks (for example, the firm would have different policies for the use of engaged specialists versus external EQRs).

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.

²⁷⁶

See PCAOB Rule 3101(a)(2).

The proposed requirement did not draw comment and has been adopted as proposed.

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.

One firm commented that the proposed specified quality responses for information and communication are appropriate. Other comments that are specific to each specified quality response are discussed below under the relevant paragraph.

.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* to the extent and 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.

The requirement carries forward an existing requirement from our QC standards and extends it to cover other participants, not just firm personnel.²⁷⁷ One firm suggested that, as it relates to other participants, the quality objective in paragraph .53g. was sufficient, and the specified quality response was not needed. Another firm commented that it is concerned that expanding the requirement to communicate quality control policies and procedures beyond firm personnel to include other participants may not be operational due to the size, content, and methods of accessing the policies and procedures. The firm further asserted that the proposed standard may inappropriately blur the lines between a firm's system of quality

²⁷⁷ See QC 20.23.

control and engagement-level requirements that are already addressed through existing PCAOB standards and rules. We believe that other participants play an important role in the operation of the firm's QC system and the performance of its engagements and that it is imperative for these other participants to be aware of the firm's policies and procedures to the extent required to enable them to carry out their responsibilities. For that reason, we believe it is necessary to expand the existing requirement to include other participants in a specified quality response.

To address the concern about the volume of material required to be shared with other participants, we have clarified the requirement by providing that policies and procedures should be communicated "to the extent" and in a manner reasonably designed to enable firm personnel and other participants to carry out their responsibilities; in other words, the requirement is to communicate what firm personnel and other participants need to know, not necessarily all of the firm's policies and procedures. 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 requirement is different, the substance of the existing requirement²⁷⁸ is unchanged. Reference to "reasonably designed and implemented" captures 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 QC standard.

Another commenter requested clarification as to whether the communication of policies and procedures is required in narrative, flowchart, or other form. We believe that the policies and procedures should be in writing and in a manner that is reasonably designed 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. The format of these policies and procedures may vary depending on the specific responsibilities being addressed and how the firm wants to communicate them.

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 specified quality response will require such communication.

²⁷⁸ See QC 20.18.

.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 a 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.

Given the importance of information generated from the monitoring and remediation process, the standard includes a specified quality response that requires 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.

One firm asserted that the requirement to communicate identified engagement deficiencies and QC deficiencies to firm personnel could hold firms to a higher standard than may be prudent, and that a perceived requirement to communicate each engagement deficiency seems imbalanced to appropriately influence change. The specified quality response requires that such communications be made to enable firm personnel to take timely action in accordance with their responsibilities. Based on the results of the monitoring and remediation process, the firm can assess the nature and extent of the communications to be made, and this should be commensurate with the risk that other similar unidentified engagement deficiencies exist; for example, for engagement deficiencies related to the examination of broker-dealer compliance reports, the firm may limit the communications to firm personnel working on broker-dealer engagements and adjacent industry sectors.

In addition, the firm is 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 requirement reinforces 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;²⁷⁹
- Weaknesses identified in the QC system or the level of understanding or compliance therewith;²⁸⁰
- Internal inspection findings;²⁸¹
- 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;²⁸²
- Additions to the Restricted Entity List;²⁸³ and
- Notification to the SEC of resignations and dismissals from audit engagements for SEC registrants.²⁸⁴

The standard, by contrast, more broadly addresses the firm's responsibilities regarding its information system and internal and external communications.

²⁷⁹ See QC 20.23.

²⁸⁰ See QC 30.03.

²⁸¹ See QC 30.06.

²⁸² See SECPS §§ 1000.08(l), 1000.42.

²⁸³ See SECPS § 1000.46 (requirement 5).

²⁸⁴ See SECPS § 1000.08(m); see also Appendix 5 for a proposed new standard, AS 1310, *Notification of Termination of the Auditor-Issuer Relationship*, that would retain existing requirements of SECPS § 1000.08(m) and apply those requirements to all firms.

K. Monitoring and Remediation Process

1. 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 will help the firm identify and assess new and evolving quality risks and design and implement effective quality responses. It drives 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 the monitoring and remediation component, and provides the basis for a firm's evaluation of whether its QC system is effective and for reporting on the QC system.²⁸⁵

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 QC 1000, the monitoring and remediation process addresses the following:

- General requirements;
- Engagement monitoring activities;
- QC system-level monitoring activities;

²⁸⁵

For further discussion of the evaluation of a firm's QC system, see Section IV.L below.

- Monitoring activities performed by a network;
- Determining whether engagement deficiencies exist;
- Responding to engagement deficiencies;
- Determining whether QC observations exist;
- Determining whether QC deficiencies exist;
- Responding to QC deficiencies; and
- Monitoring the implementation and operating effectiveness of remedial actions.

Under the standard, a firm performs 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 are to be evaluated annually as part of the evaluation of the QC system. Therefore, the monitoring 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 timely detection of *engagement deficiencies* and *QC deficiencies*; and
 - c. Remediate identified *engagement deficiencies* and *QC deficiencies* and take any other required actions in relation to such deficiencies in accordance with *applicable professional and legal requirements* on a timely basis.

The standard specifies three goals 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, and conditions related to an engagement that was subject to internal or external monitoring activities where no deficiencies were identified may provide insights about good practices to use when addressing issues on similar engagements.

- Reasonable basis for timely detection of engagement deficiencies and QC deficiencies. The standard uses the concept of “reasonable basis,” which is present throughout PCAOB auditing standards, including the standards governing the auditor’s report.²⁸⁶ Therefore, this concept is well understood by the profession. “Timely” as it relates to the detection of engagement deficiencies means that the firm’s monitoring activities are designed to identify deficiencies as promptly as practicable. For example, we expect that the firm’s monitoring activities will generally enable the firm to identify deficiencies in calendar year-end engagements in time to include them in its evaluation of the QC system as of the following September 30.
- 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 observations* 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).

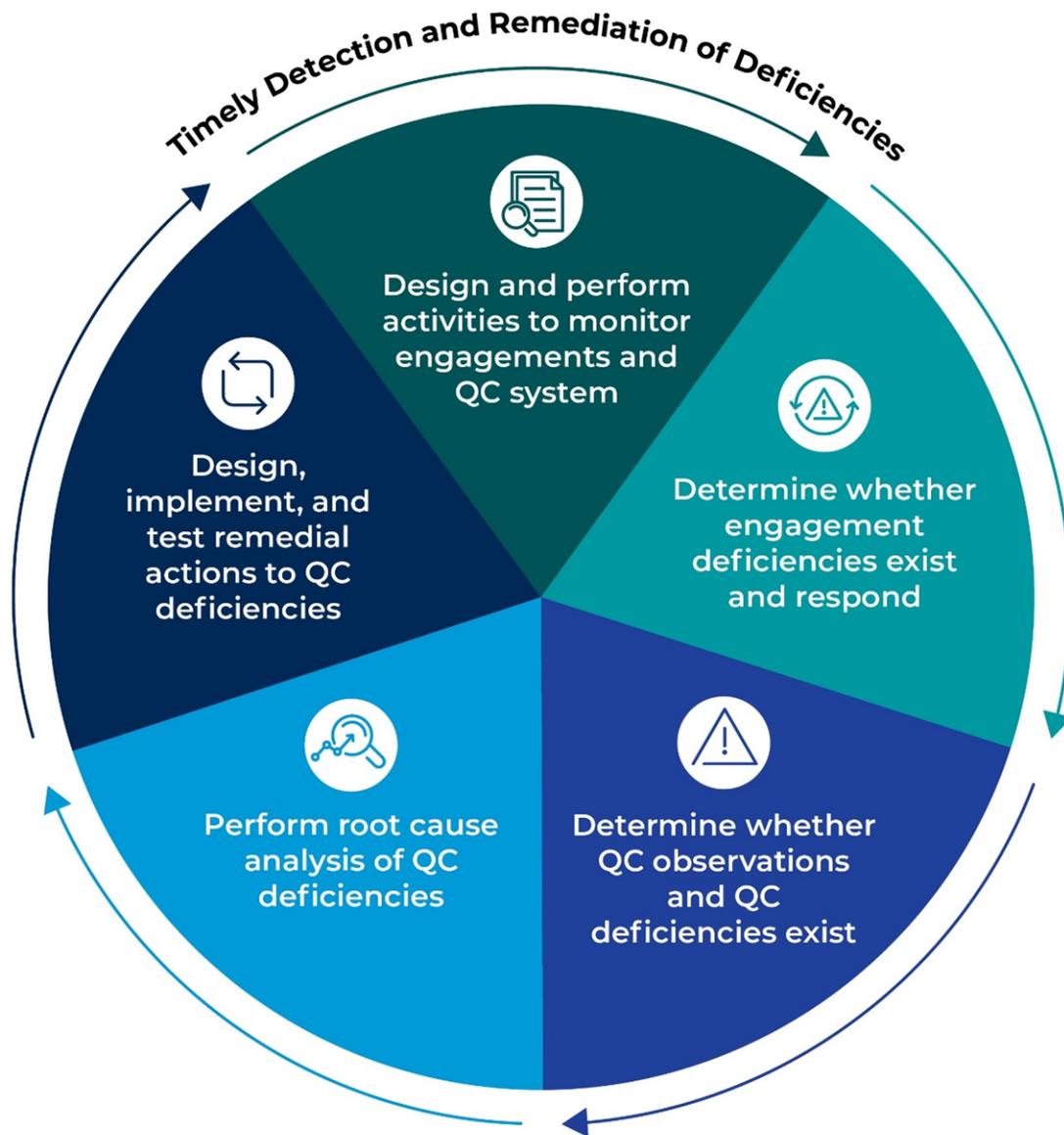
²⁸⁶ See, e.g., AS 3101.09f (noting that one of the elements in the Basis for Opinion section of the auditor’s report is “[a] statement that the auditor believes that the audit provides a reasonable basis for the auditor’s opinion”).

The first element of monitoring and remediation is designing and performing monitoring activities for engagements and the QC system itself. 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 from time to time at set intervals. 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 standard are:

- Determining whether engagement deficiencies exist and responding to them.
- Determining whether QC observations exist.
- 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 requirements of paragraphs .61-.76.



.61 The firm’s monitoring activities must include:

- a. “*Engagement* monitoring activities,” which are directed at individual *engagements*; and

Note: For firms that issued *engagement* reports with respect to five or fewer *engagements* for issuers, brokers, and dealers during the prior calendar year, *engagement* monitoring activities may include monitoring audits not performed

under PCAOB auditing standards, provided that such audits are selected taking into account the factors in paragraph .64 and that instances of noncompliance with applicable auditing standards identified through monitoring are treated as if they were “engagement deficiencies” for purposes of paragraph .68d and “QC observations” for purposes of paragraph .72. Audits not performed under PCAOB auditing standards cannot be included in the monitoring required under paragraph .62b.

- 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.

Note: In accordance with paragraph .44e, it is a quality objective that individuals performing monitoring activities have, among other things, the objectivity needed to perform such activities in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures. Generally, individuals cannot perform monitoring activities over their own work.

QC 1000 requires that the firm’s QC system include both engagement monitoring activities and QC system-level monitoring activities. The standard differentiates engagement monitoring activities from QC system-level monitoring activities. The two types of activities 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. Engagement monitoring activities are monitoring procedures performed on engagements, 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.

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 acceptance and continuance of engagements that would also address the design, implementation, and operation of the acceptance and continuance of engagements component of the firm’s QC system.

QC 1000 defines “engagement” as any audit, attestation, review, or other engagement performed under PCAOB standards (1) led by a firm or (2) in which a firm plays a substantial role in the preparation or furnishing of an engagement report. Under the standard, 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, while such work would not be treated as the firm's own "engagement" for purposes of the standard, any firm that was required to implement and operate an effective QC system under the standard is 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.

In general, for purposes of QC 1000, engagement monitoring activities are performed only on "engagements" as that term is defined in the standard. One firm suggested that audit quality should consistently be measured for all engagements, whether performed under the PCAOB standards or other auditing standards, and therefore a firm's QC system should provide reasonable assurance of performing all such engagements in compliance with applicable laws and professional requirements. This firm urged the Board to consider whether the monitoring-related requirements in QC 1000 that use the term "engagements" (as defined in QC 1000) may result in a lost opportunity to fully capitalize on the expected benefits of a more comprehensive monitoring program. Given the limits of our statutory authority under Sarbanes-Oxley, we do not believe it would be appropriate for us to expand the scope of the term "engagements" to include work performed under standards of other standard-setters. However, nothing prevents firms from developing a single QC system for their entire audit practice that satisfies both PCAOB requirements and other professional standards to which the firm is subject, which could include performing the same types of monitoring activities for both PCAOB engagements and other audits.

We also understand that firms that perform only a small number of issuer and broker-dealer engagements would be significantly affected by a requirement to perform monitoring activities over PCAOB "engagements" every year.²⁸⁷ In the extreme case, a firm that issues an audit report for only one issuer would have to monitor the same engagement every year. The prospect of annual monitoring could disincentivize partners from serving as the engagement partner and ultimately affect competitive conditions in the market. Accordingly, we have included a note to paragraph .61a that permits firms that issued engagement reports for five or fewer issuers, brokers, and dealers in the previous year to include audits not performed under PCAOB auditing standards in their engagement monitoring activities for purposes of QC 1000, so long as the audits are selected taking into account the factors in determining the nature, timing, and extent of engagement monitoring activities set forth in paragraph .64. This accommodation takes into consideration the structure of the SEC's partner rotation requirements exemption for small firms,²⁸⁸ and is limited to audits rather than attestation work because audits are performed under more rigorous standards. These firms will still have to

²⁸⁷ Firms that issued audit opinions for between one and five issuers or broker-dealers represented 38% of all registered firms in 2022, 39% in 2021, and 43% in 2020.

²⁸⁸ See Regulation S-X Rule 2-01(c)(6)(ii), 17 C.F.R. § 210.2-01(c)(6)(ii).

design, implement, and operate a monitoring and remediation process that meets the requirements of QC 1000, including the requirements regarding the objectives and elements of the monitoring and remediation process set forth in paragraphs .59 and .60, which focus on “engagements” as defined in the standard. The firms will also be subject to the requirement under paragraph .62b to inspect at least one completed PCAOB engagement for each engagement partner on a cyclical basis, as discussed below.

Current PCAOB QC standards provide that, in some circumstances, individuals may perform monitoring procedures over the same areas for which they are responsible.²⁸⁹ Such monitoring procedures are a type of self-assessment and under the proposed standard, self-assessments would not have been permissible. Individuals would lack the requisite objectivity if they reviewed engagements in which they participated (or, in the case of audits, for which they performed the engagement quality review), or monitoring activities for which they participated in the design, implementation, or operation of the activity.

Two commenters agreed that self-assessment should not be permitted in QC 1000. Other commenters, including firms and a related group, raised concerns regarding the proposal’s disallowance of self-assessments as part of a firm’s monitoring and remediation process. Specific concerns included the impact of this requirement on smaller firms and the resource constraint that may be very difficult for firms to overcome if individuals who may be involved in an engagement through consulting with engagement teams, evaluating engagement team progress, or monitoring turnover on the engagement team are ineligible to perform monitoring activities.

While we appreciate the concerns around resource constraints raised by commenters, allowing individuals to review their own work is inconsistent with the quality objective in paragraph .44e that individuals assigned to perform activities within the QC system have the objectivity needed to perform such activities in accordance with applicable professional and legal requirements and the firm’s policies and procedures. Taking into account commenter feedback, we have added a note to the standard to clarify that the restriction on self-assessment is grounded in that quality objective. The note further explains the implication, in the context of the monitoring and remediation process, that individuals generally cannot perform monitoring activities over their own work, for example by performing engagement monitoring activities on an area of an engagement in which they participated. The impact of this restriction will depend on the role that the individual played in the engagement. For example, individuals who have consulted on a particular area of an engagement would be permitted to perform monitoring activities on other areas of an engagement that were unrelated to the consultation. However, individuals that served as the engagement quality

²⁸⁹ See QC 30.10, which applies to small firms with a limited number of management-level individuals.

reviewer on an engagement may not perform monitoring activities on that engagement, even if they did not review every area of the engagement.

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 incorporate a level of unpredictability in their selection and monitoring of completed *engagements*, such that an engagement partner would not be certain of at least one of: (i) which *engagement* would be selected, (ii) which areas within the *engagement* would be selected, or (iii) when an *engagement* would be selected. While some firms may be permitted to perform *engagement* monitoring activities on audits not performed under PCAOB auditing standards (see Note to paragraph .61a), inspections under this subparagraph b must be of *engagements*.

Similar to the proposal, the final standard requires firms to perform engagement monitoring activities on completed engagements. Two commenters expressed support for the requirement to monitor completed engagements. One commenter suggested that paragraph .62 be amended to permit the legacy flexibility of QC 20 for a firm to have preissuance or postissuance, or both, monitoring programs, depending on the individual firm's risk

assessment. This commenter asserted that some smaller firms, in particular, have already implemented robust preissuance quality monitoring reviews on substantially all issuer audits.

We continue to believe that 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. We also note that the standard does not prescribe specific monitoring activities, so firms will be able to determine what activities to perform when monitoring completed engagements. Based on our oversight activities, we have observed that 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 most instances.

The proposed standard also included a requirement for 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. Some firms and a related group supported that requirement in principle. Some commenters suggested that firms should be permitted to include all of the engagements within a particular engagement partner's portfolio of engagements, not only PCAOB engagements, since the firm operates a single QC system. One commenter stressed that if firms are not permitted to consider all engagements in an engagement partner's portfolio, it may unnecessarily drive firms to two separate cyclical inspection programs (that is, doubling inspection program activities) based on the applicable set of professional standards. This commenter also suggested that the standard should allow firms to consider whether engagement partners have been subjected to external inspections/reviews when determining if, and when, to subject them to an internal inspection.

Similar to the proposal, the final standard requires firms to inspect at least one completed PCAOB engagement for each engagement partner over a cyclical period. Although, as discussed above, firms with five or fewer issuer and broker-dealer engagements may be permitted to include non-PCAOB engagements in their monitoring activities, inspections under this paragraph must be of "engagements" as defined in QC 1000. This will ensure that firms regularly evaluate the work of every partner under PCAOB standards to determine whether engagement deficiencies or QC deficiencies have occurred and can design and implement appropriate remedial actions. The note to the final standard clarifies that point.

The proposed standard also included a note stating 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. Several commenters, including an investor-related group, disagreed with this aspect of the proposal, suggesting that each firm should be allowed to determine the appropriate cycle for engagement partner selection. Some of these commenters stated that requiring a set interval for engagement partner selection could actually

result in a reduced ability by the firm to incorporate unpredictability into the selection process. One firm further stated that the proposed requirement regarding the engagement partner selection cycle could also decrease the frequency of other monitoring activities, such as in-process reviews, or curb investment and innovation in preissuance monitoring programs.

We continue to believe it is appropriate to incorporate an expectation that each engagement partner will be subject to inspection at least every three years, and are adopting that aspect as proposed. A three-year period appears to be a norm for other standard setters and, based on our oversight activities, is common in practice.²⁹⁰ We appreciate that requiring a set interval could make the timing of selection predictable for an engagement partner, so a three-year cycle is a baseline expectation, not a requirement. Firms can of course adopt a shorter cycle, or can adopt a longer cycle if they are able to demonstrate how that cycle is adequate to provide a reasonable basis for detecting engagement deficiencies and QC deficiencies. 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 proposed note to paragraph .62b also included language requiring firms to consider incorporating a level of unpredictability when determining when, during the cyclical period, an engagement partner has an engagement selected for monitoring and which completed engagement(s) to select. This was intended to 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. However, commenters, including firms and investors and related groups, suggested that this language should be strengthened to require that the firm "should" incorporate unpredictability into the selection process. One of these commenters went further to suggest that we also incorporate language requiring unpredictability in the focus areas subject to internal inspection monitoring, in addition to the timing of such monitoring. We agree with the comments raised with respect to requiring firms to incorporate unpredictability into their selection process and this change is reflected in the note to paragraph .62b. Additionally, in order to allow sufficient flexibility for firms to determine how to incorporate unpredictability in the selection process, language has been added to the note to clarify that the firm should include an element of unpredictability in "at least one of" the elements listed in the note to paragraph .62b.

The firm's selection of completed engagements should be responsive to information obtained from various sources, including prior monitoring activities. The standard, in paragraph .64 (discussed further below), includes factors for a firm to take into account when selecting

²⁹⁰ 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.

engagements for monitoring. These factors will assist a firm when determining its cyclical basis and selecting at least one engagement to inspect for each engagement partner.

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 *engagements*, the firm should consider performing monitoring activities on such work.

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 or used a specific tool or template (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 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 the issue 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).

The proposed standard contemplated that firms that issue audit reports with respect to more than 100 issuers during the prior calendar year would be required to monitor in-process engagements. The proposal noted that we understand that monitoring in-process engagements may be challenging for some firms based on their size and nature, so the proposed standard also included 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.

Firms that commented on this requirement supported the concept of monitoring in-process engagements and the flexibility the standard provided for firms to design their in-process monitoring based on the nature and circumstances of the firm. Two firms stated that the purposes of in-process monitoring are clear and appropriate and that the proposed standard clearly distinguished between in-process engagement monitoring and engagement quality reviews under AS 1220. Two firms suggested that the 100-issuer threshold is not necessary, and that all firms should only be required to consider whether to monitor in-process engagements.

We believe that differentiating a firm’s obligation based on the number of issuer clients is appropriate because, in our view, firms with larger, more complex audit practices generally are subject to quality risks for which in-process monitoring is an appropriate quality response. We are basing 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 III.C. above, firms are familiar with the threshold of more than 100 issuer audit reports. 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 could significantly change current practice and is not justified by the circumstances of every firm. However, due to the benefits of this proactive engagement monitoring, we are requiring that firms that do not meet the 100-issuer threshold should consider monitoring in-process engagements. We believe that this approach strikes an appropriate balance between prescriptiveness and scalability, and are adopting the requirement as proposed.

One individual commenter suggested that audit firms would find it cost prohibitive to build in “in process” controls that would be akin to doing an inspection of an audit in process, with the exception of certain circumstances, but we did not receive any specific comments

from firms expressing that concern. 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.²⁹¹

In situations where the firm participates in another firm's engagement but does not play a substantial role, paragraph .63c provides that the firm should consider performing monitoring activities on such work. Some commenters agreed with the requirement for firms to consider performing monitoring activities on their work on other firms' engagements. When deciding whether and when to do so, and what monitoring activities to perform, firms would take into account the factors identified in paragraph .64, 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 to work performed on other firms' engagements at less than a substantial role, the firm would have to make that decision in light of the overall objectives of the QC system.²⁹²

One commenter requested clarification as to whether the in-process monitoring activities the Board has observed would be sufficient to meet the requirement, or whether we expect such activities to be expanded or enhanced. The standard does not specify any particular monitoring activities, so the firm has discretion to select activities based on the nature and circumstances of the firm and its engagements and the scope and nature of its other monitoring activities. For example, when determining which engagements to select for in-process monitoring, a firm would leverage the factors presented in paragraph .64 of the standard to identify engagements where there is a greater risk of noncompliance with applicable professional or legal requirements. Similarly, these factors will also assist a firm in determining the riskier areas of such engagements upon which to perform in-process engagement monitoring activities.

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. *Quality responses*, including their timing, frequency, scope, and operation;

²⁹¹ In 2023, eleven of the fourteen annually inspected firms performed some in-process engagement monitoring activities.

²⁹² See QC 1000.05a.(2).

- c. The nature, timing, extent, and results of previous monitoring activities undertaken by the firm and, if applicable, a network, including from inspections of completed *engagements*, monitoring 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 a 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 *engagement* monitoring activities.

- 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 company 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 *quality risks*, 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, and other events affecting one or more *engagements*.

Similar to the proposal, the final standard requires a firm to take into account certain factors 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 will need to tailor its monitoring activities to address the particular circumstances of the firm and select engagements for monitoring based upon their specific risks.

The factors are:

- Quality risks and the reason for their assessments, and 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 would design its engagement monitoring activities to verify the engagement team's use of the practice aid. The earlier these monitoring activities are performed, the more proactive the firm could be in planning audit procedures that address audit issues as they arise. Regarding the proposed factor in paragraph .64b related to the "design of the quality responses," we have removed the word "design" from the factor and made other edits to clarify that the firm should also take into account the scope and operation of quality responses, for example related to information about how those quality responses operated in previous years.
- The nature, timing, extent, and results of previous monitoring activities. This includes insights learned from previous engagements and QC system-level monitoring activities that are 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 may 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. One commenter recommended a clarifying revision to paragraph .64c to change the reference to "inspections of in-process engagements" to "monitoring of in-process engagements." The commenter explained that the characterization of in-process engagement monitoring as an "inspection" is not consistent with how in-process engagement monitoring was described in the proposal, as the in-process monitoring activities observed by the PCAOB do not include inspections of in-process engagements. We agree and have included this revision in the final standard.
- Information obtained from oversight activities by regulators, other external inspections or reviews, and, if applicable, monitoring activities performed by a network. Information obtained from network monitoring activities or external reviews provides 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.

The proposal included a note that a firm cannot rely solely on network monitoring activities or external inspections by regulators of individual engagements without performing its own inspections of completed engagements. One commenter, a firm, agreed with the proposed requirements for firms to perform their own monitoring activities rather than solely relying on the monitoring activities performed by the network. Another firm disagreed and recommended that the standard permit networks to perform monitoring activities on behalf of a member firm, including in certain circumstances as the sole source of a firm's QC engagement monitoring. This commenter stated that monitoring of completed and in-process engagements by the network may provide member firms in the network with more objective and experienced monitoring resources, and that smaller member firms may not have the resources to perform objective monitoring on completed and/or in-process engagements without leveraging the network. Similar to what we describe below as it relates to a firm's QC system and the extent of monitoring activities performed by a network, regardless of whether a network performs engagement monitoring activities on a firm's engagements, the firm is ultimately responsible for its QC system and for evaluating any information it obtains from the network about any engagement monitoring activities the network performs. The firm would take into account the nature and extent of activities performed by a network in designing and implementing its own activities but all firms are required to perform some level of engagement monitoring. The final standard includes a clarifying revision to this note that replaces "inspections of completed engagements" with "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 affect the quality risks associated with an engagement, whether positively or negatively. For example, an engagement partner's lack of experience in an industry the company under audit recently entered may create additional risks to complying with applicable professional and legal requirements. Therefore, performing engagement monitoring activities on such engagements may be appropriate.

- Other information relevant to the quality risks. The standard includes a non-exhaustive list of examples. For clarity, we have rephrased it in terms of “quality risks” rather than “risks of noncompliance with applicable professional and legal requirements.” The standard also includes a footnote referencing footnote 26, which explains that the firm is deemed “aware” of information when any partner, shareholder, member, or other principal of the firm first becomes aware of such information.

The 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 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. *Quality responses*, including their timing, frequency, scope, and operation;
- c. For monitoring activities over the firm’s risk assessment process and monitoring and remediation process, the design of those processes (including any metrics the firm may use in 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 a 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.

Similar to the proposal, the final standard requires a firm to take into account certain factors 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 is required to take into account when determining the nature, timing, and extent of engagement monitoring activities, such as the quality responses, including their timing, frequency, scope and operation. Regarding the proposed factor in paragraph .65b related to the “design of the quality responses,” conforming to the change made in paragraph .64b, we have removed the word “design” from the factor and made other edits to clarify that the firm should also take into account the scope and operation of quality responses, for example related to information about how those quality responses operated in previous years. The specific features of a firm’s quality responses are also 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 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 standard requires 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 is 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 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 is continuously evolving in response to changes in risks, the firm would have to consider whether and how such changes necessitate changes to the nature, timing, and extent of QC-system level monitoring activities. For example, changes to a quality response would be an indication that changes to the activities that monitor the design, implementation, and operation of

such response may be necessary. It should be noted that, even in the absence of changes in the QC system, for example in cases where the firm determines that there have been no changes related to a particular quality response, the firm would still need to consider whether previous monitoring activities related to that quality response continue to provide the firm with a reasonable basis to evaluate the QC system, including the appropriateness of the firm's monitoring activities for the current period.

- 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). The firm would take that into account when deciding what QC system-level monitoring activities to undertake (for example, assessing other participants' compliance with PCAOB standards regarding engagement quality reviews).²⁹³

A firm's monitoring activities are likely to vary over time as a firm takes into account the factors included in the standard (see paragraphs .64–.65). Since a firm's QC system is a continuous and iterative process, such factors will generally lead a firm to perform different monitoring activities or employ different monitoring approaches over time.

Several commenters, including investor-related groups, suggested that the standard should require that the monitoring and remediation process, or more generally QC 1000, provide for use of quantitative metrics. QC 1000 does not require firms to use quantifiable metrics in their monitoring activities or suggest the use of any particular metrics. The Board has recently proposed a new set of firm reporting requirements that includes both firm-level and engagement-level metrics, and we address the comments regarding metrics received in response to the QC 1000 proposal in that proposing release.²⁹⁴

Other than removing the word "performance" from the phrase "performance metrics," to align with the terminology used in our proposed metrics requirements, we are adopting as proposed paragraph .65c, which requires the firm to take into account any metrics that the firm may use in its QC system when determining the nature, timing, and extent of QC system-level monitoring activities. This could include, but is not required to include, any metrics firms would be required to report if the metrics proposal is ultimately adopted by the Board and approved by the SEC, as well as any additional metrics a firm may develop. Depending on their circumstances, firms may find that developing 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.

²⁹³ See generally, e.g., AS 1220.

²⁹⁴ See PCAOB Rel. No. 2024-002 at 12-13.

e. Monitoring activities performed by a network

.66 In circumstances when a 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*.

We are adopting substantially as proposed the requirements that apply when networks perform monitoring activities relating to a firm's QC system or 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.

The nature and extent of a network's monitoring activities will 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 is required to evaluate the monitoring activities performed by the network on the tracking system. In performing its evaluation, the firm needs 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 is also 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. Under this example, 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 standard, the firm is responsible for evaluating any information it obtains from the network about any QC monitoring activities the network performs. Some commenters, all of which were firms, supported the proposed requirements related to monitoring activities performed by a network.

A firm is 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. One commenter expressed concern that the proposal allows the firm to request certain categories of information from a network but does not require that the information actually be received. In situations where a firm does not receive information requested from the network about the monitoring activities the network performed, the firm 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 will need to evaluate that member firm's competence and ability using a different approach.²⁹⁵ To illustrate another case, if a firm requests but does not receive any information from the network regarding QC monitoring activities related to independence that the network performed on behalf of the firm, and the firm does not perform any monitoring activities related to its QC system in that area, the firm would have no basis for concluding that the quality objectives related to independence were achieved.

f. Determining whether engagement deficiencies exist

.67 The firm must, on a timely basis, evaluate the following information and determine whether *engagement deficiencies* exist:

- a. Information from *engagement* monitoring activities;

²⁹⁵ 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.

- b. *QC deficiencies* identified by QC system-level monitoring activities, as provided in paragraph .72;
- c. Information from monitoring activities performed by a 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 or other complaints regarding either a company or the firm; and (5) restatements.

The requirements for determining whether engagement deficiencies exist did not draw comment and are adopted with one modification, described below.

As defined by the 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,²⁹⁶ not making required communications to the audit committee,²⁹⁷ or not filing Form AP.²⁹⁸

The standard requires a firm to evaluate a variety 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 standard, a firm is not expected to seek out other sources of information that may indicate an engagement deficiency exists. However, if the firm becomes aware of such information, the firm is expected to evaluate it. For purposes of the standard, the firm is deemed “aware” of information when any partner, shareholder, member, or other principal of the firm first becomes aware of such information. We have made a change to the proposed note in paragraph .67e item (4) to clarify that complaints the firm becomes aware of, that may indicate the existence of an engagement deficiency, could be related to either a company or the firm. We also broadened the language to clarify that complaints are not limited to those submitted through a formal whistleblower program.

The standard does not specify how a firm would evaluate 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 PCAOB 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 that an engagement deficiency exists may pertain to an in-process engagement, a completed engagement, or work performed on other firms’ engagements.

If a firm obtains information about a potential deficiency in an in-process engagement, whether from monitoring activities or other sources, the firm is 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

²⁹⁶ 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*.

²⁹⁷ See generally AS 1301.

²⁹⁸ See PCAOB Rule 3211, *Auditor Reporting of Certain Audit Participants*.

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-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. QC 1000 does not have specific provisions to address remediation of this type of problem because the auditor's responsibility is already addressed by applicable professional and legal requirements. However, even in instances where an engagement deficiency does not arise because a problem was identified and corrected prior to issuance of an engagement report, a firm would still need to consider whether the existence of the problem constitutes a QC observation—an observation about the design, implementation, or operation of the firm's QC system that may indicate one or more QC deficiencies exist—and, ultimately, a QC deficiency.

By contrast, some applicable professional and legal requirements (such as those relating to preliminary engagement activities, including engagement 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 standard requires determinations to be made on a timely basis. For completed engagements, the timeliness of the determination depends 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.

The final standard has been revised to clarify that the evaluation and determination of whether engagement deficiencies exist must both be done on a timely basis.

g. 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(s) are 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: In the absence of circumstances indicating that reliance is impossible or unreasonable (e.g., cessation of a trading market for issuer securities), inclusion of an *engagement* report (either directly or through incorporation by reference) in the most recent filing on an SEC form that requires inclusion of such an engagement report evidences that the report is being relied upon.

- c. For *engagement deficiencies* relating to work performed on other firms' *engagements*, communicate the *engagement deficiency* to the other firm and take such 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 paragraphs .68a.-c. above, as applicable.

Under the final standard, when a firm determines an engagement deficiency exists, the firm is required 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 provided that the firm 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, under the proposed standard, 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; action could be performed either before the report is issued or afterwards (if afterwards, the provisions of paragraph .68b would apply). We are adopting substantially as proposed the requirement for responding to an engagement deficiency on an in-process engagement.

ii. Engagement deficiency related to a completed engagement

For an engagement deficiency related to a completed engagement, the proposed standard included a requirement for 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 paragraph .70). However, under the proposed requirement, no action would have been required if it was probable that the engagement report was not being relied upon.²⁹⁹

The proposed standard included a note that stated the firm must treat an auditor's report as being relied upon if the auditor's report is included in the most recent SEC filing on a form that requires its inclusion. Because this note also appeared in the proposed amendments to AS 2901 in paragraph .01, refer to the detailed discussion below in Section V.A.2.a.i. for commenter feedback and our responses. We have revised the note to paragraph .68b. to provide that, in the absence of circumstances indicating that reliance is impossible or unreasonable (e.g., cessation of a trading market for issuer securities), inclusion of an engagement report in the most recent filing on an SEC form that requires inclusion of such an engagement report generally evidences that the report is being relied upon. We believe this is responsive to commenter concerns and allows for sufficient flexibility for such circumstances. We have also revised the note to clarify that an engagement report can be included in an SEC filing either directly or through incorporation by reference.

iii. Engagement deficiency related to work performed on other firms' engagements

For an engagement deficiency related to work performed on other firms' engagements, the standard requires a firm to communicate to the other firm the engagement deficiency. The communication needs to be sufficient to enable the other firm to develop a response

²⁹⁹ The use of "probable" in the note to paragraph .68 is consistent with how the term is used in FASB ASC, Contingencies Topic, paragraph 450-20-25-1, which provides that an event is "probable" when it is likely to occur.

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, should be included in the population of QC observations to be evaluated to determine whether QC deficiencies exist. We did not receive comment on this aspect of the proposal and are adopting it as proposed.

iv. Evaluating whether similar engagement deficiencies exist

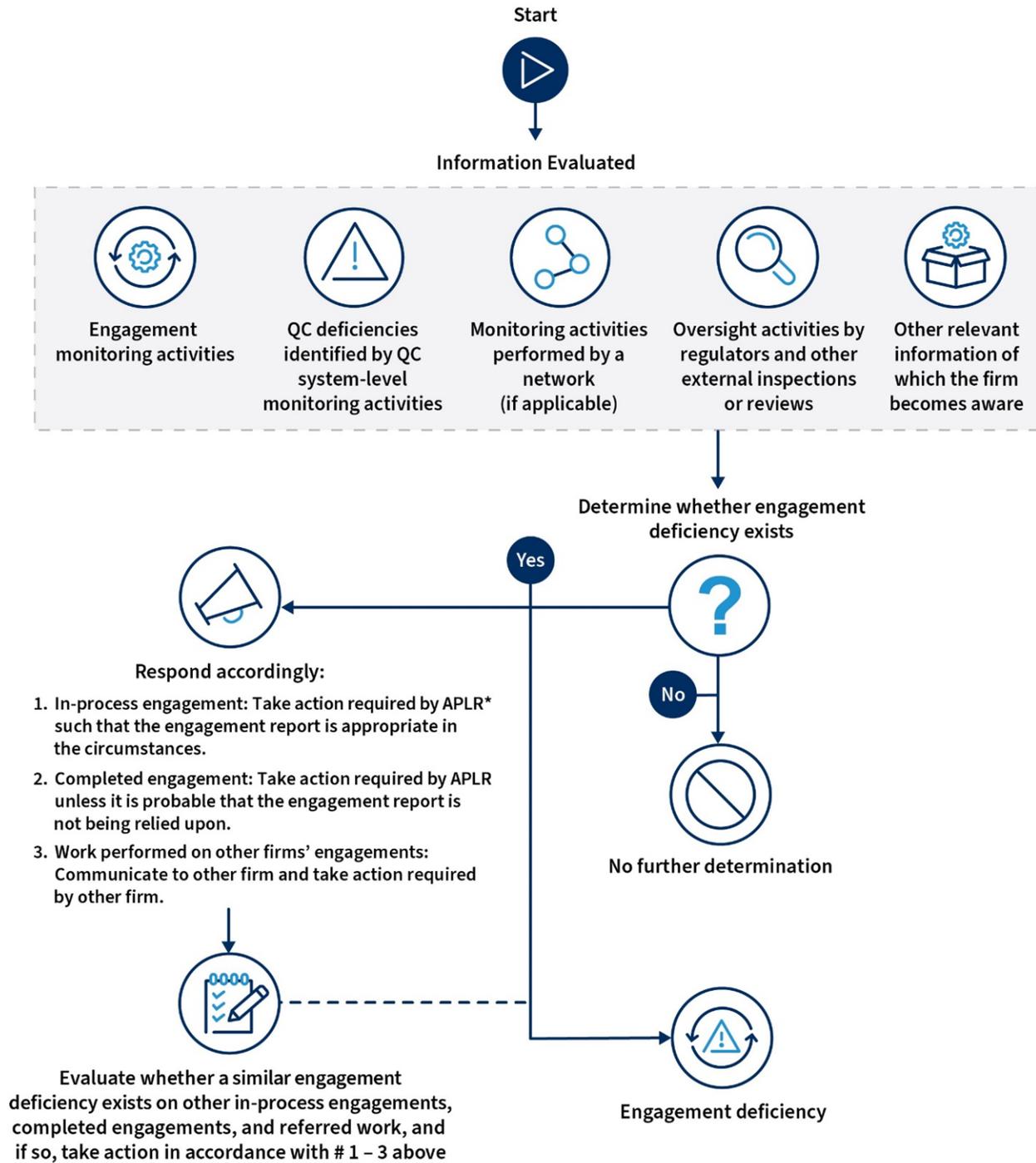
The proposed standard also required a firm to evaluate whether similar engagement deficiencies exist in other in-process engagements, completed engagements (unless it is probable that the engagement report is not being relied upon), and work performed on other firms' engagements, and if so, to take actions as required by paragraphs .68a.-c. for in-process engagements, completed engagements, and any other work performed by the firm on other firms' engagements at less than a substantial role. Understanding the nature of the engagement deficiency will 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 would 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 would 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.

One commenter requested that we provide additional examples of engagement deficiencies, as the concept of applicability to other in-process engagements could be subject to different interpretations. We will consider whether application guidance in this area would be appropriate.

Another commenter stated that the expectation of what "evaluate," as used in this context, may require is not clear and suggested that the evaluation be limited to certain engagements based on a risk-based assessment, taking into consideration the root cause of the identified engagement deficiency. As noted above, understanding the nature of the engagement deficiency would assist the firm in determining the extent of the actions to take in order to evaluate whether similar engagement deficiencies exist on other engagements.

We are adopting this aspect of the standard as proposed.

Determining the Existence of and Responding to an Engagement Deficiency



*APLR = Applicable professional and legal requirements

v. Addressing engagement deficiencies

.69 The firm should take action pursuant to paragraph .68, taking into account the nature and severity of the *engagement deficiency*.

Note: As appropriate, actions a firm may take include preventive or corrective actions, or a combination, such as actions: (1) on in-process *engagements* to address *engagement deficiencies* before the issuance of the *engagement report*; (2) to address *engagement deficiencies* on completed *engagements*; and (3) to deter future *engagement deficiencies*.

The standard requires 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 observation, is also a QC deficiency.

The 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).

The proposed note to this requirement also appeared in the proposed amendments to AS 2901.04 and a detailed discussion of commenter feedback and our views appears in Section V.A.2.b.ii. As adopted, the note in paragraph .69 includes clarifying changes. We are otherwise adopting the requirement as proposed.

.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 2901, *Responding to Engagement Deficiencies After Issuance of the Auditor’s Report*; 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*; and paragraphs 21.-24. of AT No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, as applicable.

This requirement did not draw comment and we are adopting it as proposed. Firms should comply, as applicable, with other standards related to engagement deficiencies on completed engagements.

- AS 2901 addresses auditor responsibilities with respect to engagement deficiencies on completed audit engagements. AS 2201.99 directs the auditor to comply with AS 2901 as it relates to audits of internal control over financial reporting.
- 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 incorporate responsibilities similar to those required under AS 2901 for attestation engagements relating to certain broker-dealer reports.

Section V.A below discusses the amendments to AS 2901 we are adopting today, and the text of those amendments appears in Appendix 3. The text of the amendments to AS 2201, AT No. 1, and AT No. 2 appears in Appendix 5.

h. Determining whether QC observations exist

.71 The firm must, on a timely basis, evaluate the following information and determine whether *QC observations* exist:

- a. Information from *engagement* monitoring activities and QC system-level monitoring activities (including, if applicable, those performed by a 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.

The proposed standard would have required firms to determine the existence of “QC findings,” defined as “[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.”

Commenter feedback on this defined term was in most instances directly related to the last sentence in the defined term, urging that engagement deficiencies should not automatically be considered QC findings. We are concerned that commenters may have misinterpreted “QC findings” as akin to “QC deficiencies,” whereas our intention is only to designate matters that have to be evaluated as potential QC deficiencies. To alleviate the potential confusion, we have changed the defined term to “QC observation” and reworded the definition. The definition of a QC observation in the final standard is “(1) An engagement deficiency; or (2) Any other observation about the design, implementation, or operation of the firm’s QC system that may indicate one or more QC deficiencies exist.”³⁰⁰

Under the definition, any information that may indicate a problem with the design, implementation, or operation of the firm’s QC system would be a QC observation. 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 observations. Examples of other QC observations 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 observations 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 standard, the results of all monitoring activities performed by the firm, and if applicable, those performed by a network relating to the firm’s QC system or its engagements, are required to be analyzed by the firm to determine if there are QC observations. It is possible that a firm’s engagement monitoring activities could identify not only engagement deficiencies, but also QC observations 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

³⁰⁰ QC deficiencies are defined and discussed in the next subsection. See Section IV.K.1.i.i below.

authorization to use a specific tool, that observation would be a QC observation, 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 typically has 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 observations 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 is expected to determine whether it is a QC observation. For example, the firm may become aware of an issue with a formula in a practice aid used to assist 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.

The final standard has been revised to clarify that the evaluation and determination must both be done on a timely basis.

i. Determining whether QC deficiencies exist

.72 The firm must, on a timely basis, evaluate *QC observations* and determine 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 observation*, which includes:
 - (1) The component(s) of the QC system, *quality objective(s)*, or *quality risk(s)* to which the *QC observation* relates;
 - (2) Whether the *QC observation* is in the design, implementation, or operation of the QC system;
 - (3) The frequency with which the *QC observation* occurred; and
 - (4) The duration of time that the *QC observation* existed; and
- b. The likelihood that the matter(s) that gave rise to the *QC observation* 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 standard requires firms to determine whether QC deficiencies exist, and (except for the change in terminology to “QC observation”) is adopted as proposed.

i. Definition of QC Deficiency

In response to commenter input, we have made changes to the definition of the term “QC deficiency.” As proposed, the definition provided in part that a QC deficiency was a QC finding that results in “a reduced likelihood of the firm achieving the reasonable assurance objective or one or more quality objectives,” and included a note providing examples of circumstances where that likelihood could be reduced. Two commenters questioned the operability of that aspect of the proposed definition of QC deficiency, in particular its linkage to the definition of an internal control deficiency under COSO in its integrated framework through the phrase “reduced likelihood.” Two commenters suggested that the definition of QC deficiency should incorporate the concept of “a significantly reduced likelihood.” Another commenter requested guidance relative to the application of the “reduced likelihood” model. Other commenters suggested that the definition should be more closely aligned with that of other standard setters, for example ISQM 1, by incorporating the concept of an “acceptably low level.”

Taking into account commenter feedback, the standard defines a QC deficiency as a QC observation that, based on the evaluation under paragraph .72, individually, or in combination with one or more other QC observations, evidences:

- (1) That the likelihood of the firm not achieving the reasonable assurance objective or one or more quality objectives has not been reduced to an acceptably low level;

Note: The likelihood of not achieving the reasonable assurance objective or one or more quality objectives would be above an acceptably low level 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 definition of QC deficiency incorporates an existing concept of “acceptably low level” that is currently used in PCAOB auditing standards³⁰¹ so this concept should be familiar to firms. In addition, it aligns more closely with similar definitions of other standard setters, for example the definition of “deficiency” in ISQM 1. We have made conforming changes to the note that follows subparagraph (1) of the definition.

Similar to the proposal, the definition of QC deficiency in the final standard also includes noncompliance with the requirements of the proposed standard other than documentation requirements, 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. Two commenters expressed concern with this requirement, stating that there may be instances where the firm may not comply with a requirement in the standard but the quality objectives and specified quality responses were met, and a firm should be able to apply judgment to determine whether a QC deficiency exists under those circumstances. We continue to believe that compliance with the requirements of QC 1000 is a baseline element of any firm’s QC system, such that failure to comply is always a QC deficiency, and are adopting this aspect of the QC definition as proposed.

The definition also includes noncompliance with the documentation requirements of QC 1000, 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 definition of a QC deficiency. We received no comment on this aspect of the definition of QC deficiency and are adopting it as proposed.

Under the final standard, the determination of whether something identified as a QC observation 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 actions required under paragraph .68 of QC 1000, including any root cause analysis performed. These considerations are discussed, in turn, in the following subsections.

The final standard has been revised to clarify that the evaluation and determination must both be done on a timely basis.

³⁰¹ See, e.g., AS 2315, *Audit Sampling*.

ii. Nature, severity, and pervasiveness of the matter that gave rise to the QC observation

The nature, severity, and pervasiveness of the matter that gave rise to the QC observation should be taken into account when determining whether a QC deficiency exists. For a QC observation that is also an engagement deficiency, the results of the firm's evaluation of whether a similar 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 standard explains that the nature, severity, and pervasiveness of the matter that gave rise to the QC observation includes:

- The component(s) of the QC system, quality objective(s), or quality risk(s) to which the QC observation 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 engagements because the quality risks associated with the new engagement would be mitigated by the firm's policy of not taking on new issuer audit engagements. 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 observations 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 observation is in the design, implementation, or operation of the QC system. For example, a matter that gave rise to a QC observation 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 observation occurred. Frequency relates to the number of times the matter that gave rise to the QC observation 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 observation 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 observations compared to the number of times the procedure was executed properly.

- The duration of time that the QC observation existed. Duration addresses how long the matter that gave rise to the QC observation existed. In order to understand duration, a firm would need to understand whether there were other instances prior to those initially identified by the firm as QC observations.

iii. Likelihood that the matter that gave rise to the QC observation could affect other component(s) of the QC system or other engagements, and the severity of such an effect

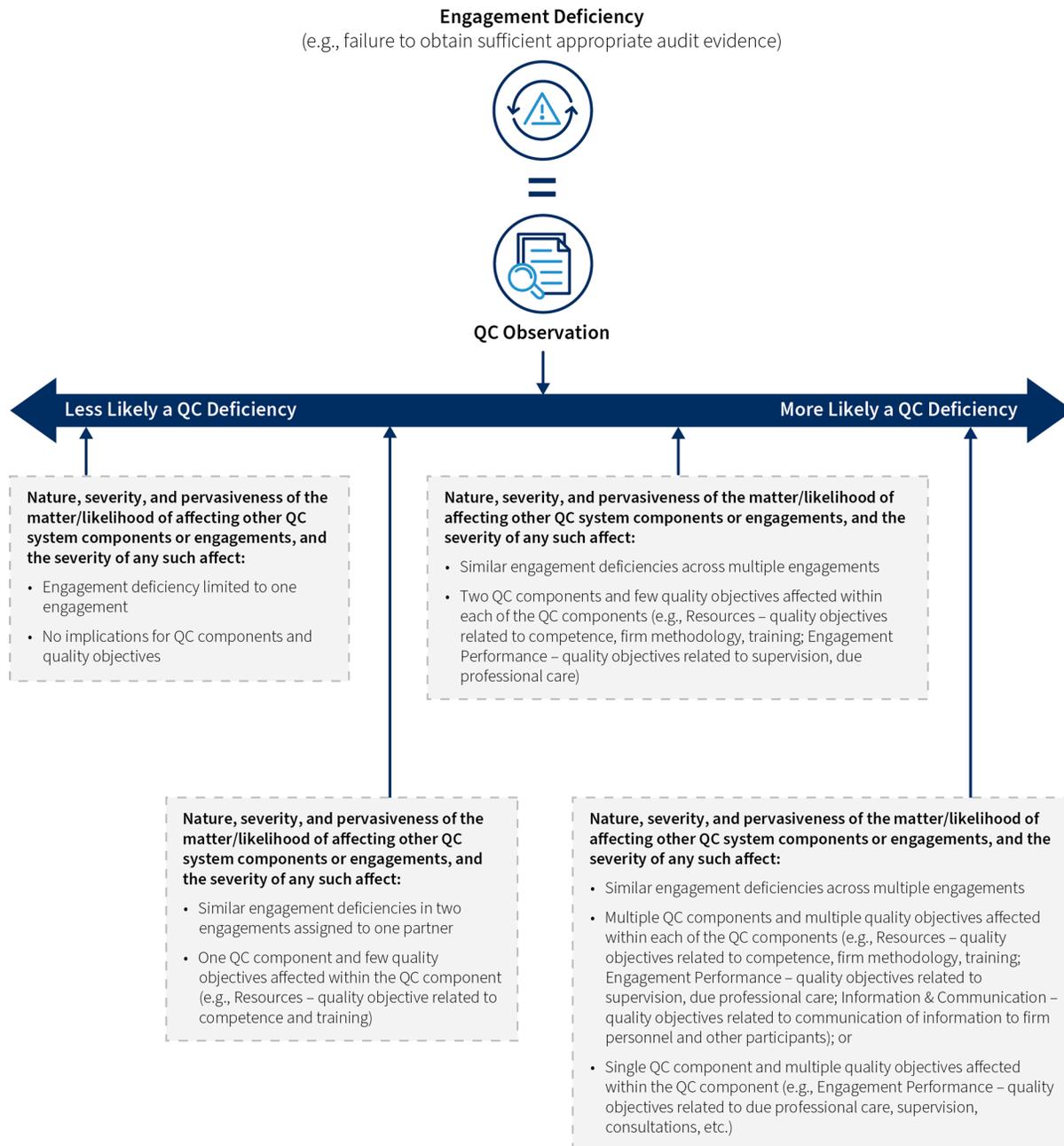
Whether a QC observation is a QC deficiency would also depend on the likelihood that the matter that gave rise to the QC observation could affect other QC system components or other engagements.

Other engagements 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. This is because the determination of whether a QC deficiency exists must be made based on the nature, severity, and pervasiveness of the matter that gave rise to the QC observation, viewed on its own. That shows the extent to which the QC system failed in allowing the underlying matter to occur. Whether the firm was subsequently able to partially or fully remediate the QC deficiency does not eliminate the fact that the failure occurred.

In addition to the likelihood of a matter's recurrence, the standard also requires a firm to evaluate the matter's severity if it were to affect other component(s) or engagements.

One commenter suggested that the standard address the concept of compensating responses as a factor when considering QC findings in proposed paragraph .72. In considering whether a QC observation is a QC deficiency (on the basis that the likelihood of the firm not achieving the reasonable assurance objective or one or more quality objectives has not been reduced to an acceptably low level) the firm could consider compensating responses that address the same quality risk. In response to this commenter's feedback, we have included additional discussion below in Section IV.K.1.j.ii.

Example of Considerations Relevant to Determining QC Deficiency



j. 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.

The requirement to perform root cause analysis on all identified QC deficiencies did not draw comment and is adopted as proposed.

Root cause analysis is a widely used concept in QC frameworks.³⁰² 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.³⁰³ 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 observation and the likelihood that the matter that gave rise to the QC observation could affect other components of the QC system or other engagements may provide evidence of what caused the problem to occur.

³⁰² See *Spotlight: Root Cause Analysis – An Effective Practice To Drive Audit Quality* (April 2024) available at https://assets.pcaobus.org/pcaob-dev/docs/default-source/documents/root-cause-spotlight.pdf?sfvrsn=55f82206_2.

³⁰³ See 2018 Inspection Observations Preview.

Root cause analysis procedures could take different forms depending on the circumstances, which allows for scalability. Some key elements that we have observed that may lead to more robust and comprehensive root cause analysis include:³⁰⁴

- Monitoring audit deficiencies identified and performing root cause analysis on a continual basis. This allows firms to obtain information that allows them to react more timely and implement remedial actions to reduce recurring deficiencies in other audits.³⁰⁵
- 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.
- 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.
- Measuring, in real time, the effectiveness of remedial actions and audit quality improvement plans or initiatives to identify whether remedial efforts are effective.

The standard does not require firms to perform root cause analysis on QC observations that are not QC deficiencies.

.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 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. This provision did not draw comment and is adopted as proposed.

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

³⁰⁴ See June 2014 SAG Briefing Paper at 2.

³⁰⁵ See *Staff Inspection Brief, Vol. 2017/4: Preview of Observations from 2016 Inspections of Auditors of Issuers* (November 2017), at 16, available at https://assets.pcaobus.org/pcaob-dev/docs/default-source/inspections/documents/inspection-brief-2017-4-issuer-results.pdf?sfvrsn=c216d8a7_0.

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 in 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.

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 requirement to design and implement timely remedial action for QC deficiencies did not attract comment and is adopted as proposed.

The timing of a firm's efforts to design and implement remedial actions depends on the results of the firm's root cause analysis and the nature, severity, and pervasiveness of the QC deficiency. We 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.

In other situations, the extent of remedial actions the firm needs to take to address a particular QC deficiency may be reduced by other compensating responses that the firm has in place. If the remedial actions, including any relevant compensating responses, have been tested and found effective in addressing the issue, the firm might determine, based on the facts and circumstances, that no further remedial action is necessary.

The process of identifying QC observations, 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 observation had such information been known at the time. If this were to occur, a firm would further evaluate the other QC observation 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 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 standard, the firm is 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 is 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.

Under the 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.

k. 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.

The requirement to monitor the implementation and operating effectiveness of remedial action for QC deficiencies did not attract comment and is adopted as proposed.

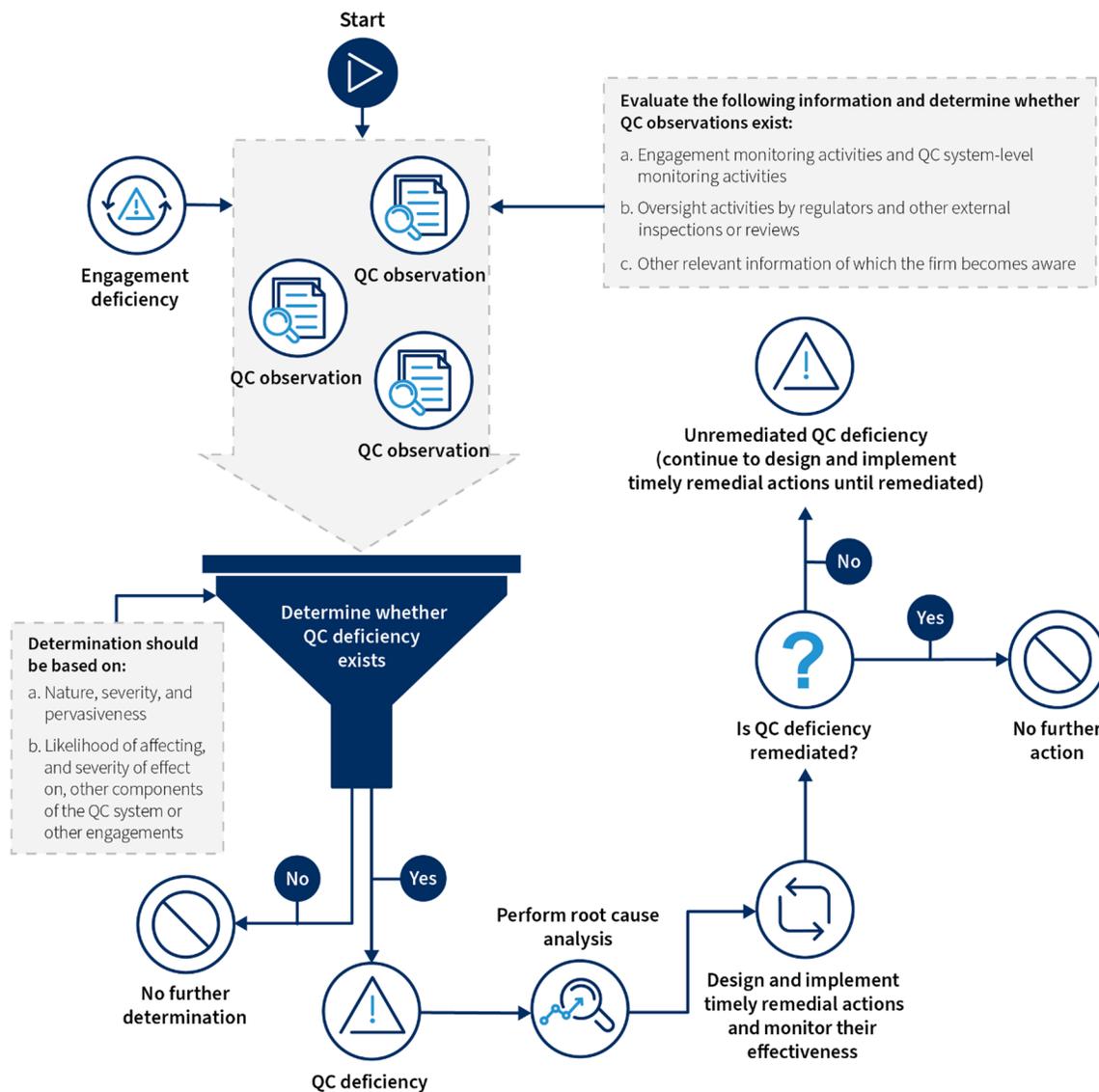
Under the final standard, a firm monitors the effectiveness of its remedial actions through engagement monitoring activities and/or QC system-level monitoring activities, depending on the nature of the QC deficiency. If a firm determines the remedial actions were not properly implemented or operating 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 is required to 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.³⁰⁶ The standards also address how a firm implements the monitoring element of a QC system in its accounting and auditing practice.³⁰⁷ 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.³⁰⁸ 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,³⁰⁹ there are no express obligations for firms to perform any specific types of monitoring.

L. Evaluation of and Reporting on the QC System

1. 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 will assist firm leadership in allocating resources to address QC deficiencies and 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.³¹⁰ However, not all firms evaluate their QC systems, and those that do may not apply the same degree of rigor.

³⁰⁶ See QC 20.20.

³⁰⁷ See generally QC 30.

³⁰⁸ See QC 30.03; QC 30.06.

³⁰⁹ See QC 30.03.

³¹⁰ See, e.g., *NYSE Listed Company Manual*, Section 303A.07(b)(iii)(A); Section 2(d) of Article 13, Regulation (EU) 537/2014.

.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 September 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.

i. Evaluation requirement

The proposed standard included 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 proposed paragraph .07c, firms that were not required to implement and operate a QC system at any time within the previous 12 months would not be subject to the requirement to evaluate and report on their QC system.

Some commenters expressed support for the proposed annual evaluation requirement. However, several commenters suggested that we conform our terminology to ISQM 1, such that the conclusions reached in evaluating the QC system would be the same under both standards. Some commenters expressed concern about the potential for stakeholder confusion because the criteria and terminology used in QC 1000 differ from ISQM 1. One commenter expressed concern that the more stringent criteria of QC 1000 would create a competitive disadvantage.

One commenter recommended that we eliminate the middle category (effective except for one or more unremediated QC deficiencies that are not major QC deficiencies), so that a firm’s QC system would be evaluated as either effective or not effective based on whether any unremediated major QC deficiencies exist as of the evaluation date, such that the reasonable assurance objective has not been achieved. The commenter analogized to ICFR reporting, where management is only required to report material weaknesses.

We have determined to adopt the evaluation requirements as proposed. We do not believe there is any likelihood of confusion among external stakeholders arising from

differences in evaluation criteria between QC 1000 and ISQM 1 because, under our final standard, the conclusion reached about the effectiveness of a firm's QC system is not required to be made public. The same is true under ISQM 1. Therefore, if a firm were to evaluate its QC system under both standards and reach different conclusions, market participants would be unaware of that fact unless the firm chose to make the results of its evaluation public (in which case, it could also choose to provide an explanation of the difference). Additionally, while ISQM 1 requires communication to those charged with governance about how the system of quality management supports the consistent performance of quality audit engagements, QC 1000 does not require any such communication to the audit committee.³¹¹ Firms would of course be free to discuss the evaluation of their QC system with the audit committee, potentially as part of the report required under listing standards that may apply to the issuer.³¹² We believe most audit committee members are already well acquainted with reviewing information prepared under different frameworks, e.g., financial statements prepared under U.S. GAAP and under IFRS, and could readily understand that the more stringent criteria under QC 1000 could lead to a different conclusion about the effectiveness of the QC system.

Similarly, we believe that firms that are required to perform multiple QC system evaluations will be able to train their personnel and acquire other resources as necessary to avoid confusion among internal stakeholders and perform the evaluation under QC 1000 appropriately. A firm will be subject to both QC 1000 and other QC standards only if it is performing audits under multiple sets of auditing standards. Just as such firms manage the differences in audit requirements and methodology associated with different auditing standards, we believe they will be capable of managing differences in the QC system requirements under QC 1000 and other QC standards, including differences in the criteria and terminology used in evaluating the QC system.

We also believe that requiring three categories for the QC system evaluation, as we proposed—effective, effective except for one or more unremediated QC deficiencies that are not major QC deficiencies, and ineffective—will result in a more rigorous QC system evaluation, a greater incentive for firms to address QC deficiencies promptly, and more detailed and informative reporting to the PCAOB. Given that reporting is only to the PCAOB, we do not believe an analogy to management's public reporting regarding ICFR, where only material weaknesses are required to be reported, is appropriate.

We are requiring that firms perform an evaluation of their QC system annually. The firm's evaluation is based on data and evidence provided by the firm's monitoring and remediation activities. An annual evaluation will provide leadership with timely information to

³¹¹ See Section IV.L.1.c.v., Reporting to the audit committee, discussed below.

³¹² See NYSE *Listed Company Manual*, Section 303A.07(b)(iii)(A).

facilitate an effective feedback loop.³¹³ This approach highlights the importance of the QC system in driving continuous improvement in firms' ability to perform compliant engagements on a consistent basis. The evaluation requirement will drive firms to collect and analyze the results of their monitoring and remediation processes in order to identify deficiencies and will provide an additional incentive for firms to focus on areas requiring the most immediate attention and improvement.

The evaluation requirement also reinforces the responsibility and accountability of leadership for the firm's QC system.³¹⁴ As discussed in Section IV.C above, the individual charged with ultimate responsibility and accountability for the QC system as a whole will 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 will be required to certify the firm's annual report regarding the evaluation of its QC system.³¹⁵ We believe this will 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.

While we are adopting as proposed a requirement for annual evaluation of the QC system, we have made some changes in response to commenter input, as described below.

ii. Evaluation frequency and date

The proposed standard would have required 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.

One commenter, an investor-related group, supported the proposed November 30 evaluation date and opposed allowing firms to set their own reporting date.

Many commenters, generally firms and firm-related groups, suggested that firms should be permitted to choose their own evaluation date, primarily because it would enable them to choose a date based on their own operating and business cycle or inspection cycle. These commenters also noted other considerations, such as alignment with the firm's fiscal year end or the date already chosen for the evaluation required under ISQM 1. Several commenters suggested that firms should be able to choose a date that would allow them sufficient time to perform root cause analysis, remediate identified issues, and test the effectiveness of their remediation efforts. One commenter noted that firms could choose a date with a view to

³¹³ 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.

³¹⁴ See QC 1000.13–.17.

³¹⁵ See QC 1000.14c.-d. and .15b.

enabling real-time conversations with audit committees. Another commenter suggested that additional flexibility on the evaluation date would enhance the scalability of the standard. Some commenters stated that requiring a specific evaluation date could lead firms to perform assessments twice a year. Several commenters also raised a concern about potential resource limitations in performing the evaluation on the timetable we proposed.

Other commenters suggested various options for potential alternative evaluation dates:

- March 31, on the basis that it is better aligned with a natural business cycle for many firms or aligns with the Form 2 reporting date. (These commenters generally preferred allowing firms to choose their own evaluation date over a mandated date applicable to all firms and suggested March 31 as a second-best approach.)
- September 30, which would allow firms to report to the PCAOB by November 15 and, in turn, report to audit committees before the end of the calendar year.
- September 30 or October 31, if the proposed January 15th reporting date is implemented, to allow additional time to complete reporting.
- February 28, to allow reporting by April 1, in advance of the April/May proxy season.
- A window, for example, November to March, within which firms could choose a date.

Taking into account commenter feedback on the proposed evaluation date of November 30, we have revised the evaluation date to September 30 for all firms. We believe this earlier date addresses commenter concerns that the November 30 date would have caused potential resource limitations during the traditional busy period for many firms. Further, we believe an evaluation date of September 30 would provide the firm with enough time to identify and potentially remediate any QC deficiencies identified from the most recent calendar year-end engagements, which might not be possible if an earlier date were selected.

As summarized above, some firms expressed concern that a firm that has already chosen its evaluation date under ISQM 1 would be required to perform two QC system evaluations per year since the PCAOB's evaluation date differs from ISQM 1's. We believe firms can build on work already done for the purpose of complying with the requirements of one QC standard in performing the other, to the extent applicable. However, since the nature of the two evaluations is inherently different (e.g., the determination of major QC deficiencies, the differing definitions of QC deficiency under QC 1000 vs. deficiency under ISQM 1), we believe that there would always be some differences between the evaluation required under QC 1000 and the evaluation required under ISQM 1. While there could be additional costs associated with multiple evaluations if a firm chose to have separate evaluation dates for purposes of QC 1000 and other QC standards to which it is subject, firms would be free to change their evaluation date under other QC standards so that the evaluation dates coincide.

The proposed standard also included a note clarifying what unremediated means in the context of this requirement: remedial actions that completely address the QC deficiency have not been fully implemented, tested, and found effective. While this note did not draw specific comment, one commenter suggested that the framework afforded by Section 104(g)(2) of Sarbanes-Oxley, which the commenter said focuses on substantial good faith progress instead of complete remediation, is necessary and should be retained. We disagree as, in our view, the two provisions serve fundamentally different purposes and a different approach is appropriate for firm evaluation and reporting under QC 1000.

Sarbanes-Oxley Section 104(g)(2) governs the circumstances under which the PCAOB is permitted to make portions of an inspection report dealing with quality control criticisms and potential defects public. It forbids publication if the criticisms or defects “are addressed by the firm, to the satisfaction of the Board,” not later than 12 months after the date of the report. In describing its process for determining whether a matter has been addressed to its satisfaction, the Board indicated that a “favorable Board determination reflects the Board’s assessment that the firm has demonstrated substantial, good faith progress toward achieving the relevant quality control objectives, sufficient to merit the result that the criticisms remain nonpublic. A favorable determination does not necessarily mean that the firm completely and permanently cured any particular quality control defect.”³¹⁶

By contrast, reporting on Form QC is simply factual: as of the evaluation date, has each identified QC deficiency been fully remediated or not? Under QC 1000, firms will perform a self-evaluation, based on the process and criteria set forth in the standard. This is very different from the process by which the Board determines whether a matter has been remediated to its satisfaction for purposes of Section 104(g)(2),³¹⁷ not least because it involves the firm’s self-assessment rather than the Board’s judgment. Moreover, we do not believe the consequences of a firm reporting an unremediated QC deficiency to the PCAOB would be the same as the consequences of the PCAOB publishing QC criticisms in an inspection report; in particular, we do not believe that the legislative policy choice reflected in Section 104(g)(2), which, as the Board has said, favors “the correction of quality control problems over the exposure of them,”³¹⁸ applies in this context, given the nonpublic nature of the Form QC reporting. Accordingly, we are adopting the note to paragraph .77 as proposed.

b. Determining whether major QC deficiencies exist

The standard requires firms to evaluate unremediated QC deficiencies as of the evaluation date to determine whether major QC deficiencies exist. While the identification of

³¹⁶ PCAOB Rel. No. 104-2006-077 at 6.

³¹⁷ See PCAOB Rule 4009, *Firm Response to Quality Control Defects*.

³¹⁸ PCAOB Rel. No. 104-2006-007 at 2.

QC deficiencies will be an ongoing process throughout the year, the determination of whether any of those QC deficiencies, alone or in combination, constitute major QC deficiencies will be required only as part of a firm's annual evaluation of its QC system.

i. Definition of a major QC deficiency

.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 whether either of the presumptions described in paragraph .78a. arises and, when relevant, the factors listed in paragraph .78b.

The proposed standard provided that a major QC deficiency was "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." One commenter supported the concept of major QC deficiency. However, a number of commenters expressed concern with that proposed definition:

- Several commenters expressed concern that the definition could cause a firm to come to a different conclusion about its QC system during the annual evaluation process under QC 1000 than the conclusion a firm may reach under ISQM 1 and suggested that the definition be revised to include the concepts of severe and pervasive, similar to the concepts that appear in relation to the evaluation of QC deficiencies under ISQM 1.
- One commenter stated that it was unclear why a new term, "major QC deficiency," would be necessary and questioned the need for a reference to a threshold other than "achieving reasonable assurance."
- Another commenter was concerned that the concept of major QC deficiency, which other QC standards do not use, will redirect time and resources to analyzing the level of a deficiency instead of the important elements to remediate the deficiency such as root cause analysis and implementing timely changes to a firm's system.
- Another commenter stated that the phrase "severely reduces the likelihood" in the definition of major QC deficiency is vague and not sufficiently defined in the proposed QC standards and suggested that the phrase be replaced with the phrase "prevents the firm from concluding."

We considered the commenter feedback and determined to adopt this language as proposed. We agree it is possible that firms could reach different conclusions as to the effectiveness of their QC system under QC 1000 and ISQM 1 or SQMS 1. However, the concept

of severe and pervasive, which commenters suggested be incorporated in the definition, appears in the factors for firms to consider when determining the existence of a major QC deficiency (see paragraph .78b. below). We believe that including this concept in the factors clarifies the process firms will need to go through in making their determination of whether a major QC deficiency exists.

The defined term “major QC deficiency” is unique to QC 1000, but the concept it embodies—that the QC system does not provide the firm with reasonable assurance that the objectives of the QC system have been met—is not, and appears in both ISQM 1 and SQMS 1. Accordingly, we do not believe that phrasing our requirements as we have, including the use of a defined term, will require a different evaluation process than if we had simply required a determination that the QC system was ineffective. We are not requiring the determination of major QC deficiencies to be performed at any time other than the evaluation date. However, firms may choose to perform such an analysis ahead of the annual evaluation date to enable sufficient time to design, implement, and test remedial actions related to the QC deficiencies that have the greatest potential impact on the QC system.

As with the defined term “QC deficiency,” the defined term “major QC deficiency” is analogous to a term in COSO’s integrated framework, major deficiency, which includes the concept of “severely reduces the likelihood.” We believe that this concept is already well-understood by firms.

Another commenter expressed concern that a major QC deficiency would exist if there was a severely reduced likelihood that the firm did not achieve a single quality objective, even when the firm had in fact achieved the reasonable assurance objective. In our view, this concern is more theoretical than real. The quality objectives in QC 1000 relate to compliance with applicable professional and legal requirements in each component of the QC system and in the aspects of the firm’s practice that are addressed by each component. Failing to achieve such a quality objective implies that the reasonable assurance objective has not been achieved. Some quality objectives, particularly in the resources component, also relate to compliance with the firm’s policies and procedures. These quality objectives are directed to the QC system itself: compliance with policies and procedures is necessary for the QC system to operate as designed. While failure to comply with firm policies and procedures does not necessarily imply failure to comply with applicable professional and legal requirements, it does mean that the QC system is not operating as designed, which may raise questions about the level of assurance it provides.

In response to commenter feedback regarding the proposed concept of presumed major QC deficiencies (discussed in the next section) we have clarified in the lead-in language of paragraph .78 that the factors in paragraph .78b are to be applied by the firm both (i) when a presumption arises that a major QC deficiency exists and the firm attempts to rebut the presumption, and (ii) in instances where no presumption arises.

ii. Presumed major QC deficiency

a. A *major QC deficiency* would be presumed to exist if there is an unremediated *QC deficiency* or combination of unremediated *QC deficiencies* that:

- (1) Relates to the firm's governance and leadership that affect the overall environment supporting the operation of the QC system; or
- (2) 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* (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).

Note: A firm may rebut the presumption that a *major QC deficiency* exists only if the firm demonstrates, taking into account both factors listed in paragraph .78b. (including all of the listed examples in paragraph .78b.(1)), that the unremediated *QC deficiency* or combination of unremediated *QC deficiencies* does not constitute a *major QC deficiency*.

The proposed definition of a major QC deficiency provided for two circumstances that would be presumed to evidence a major QC deficiency. These circumstances included 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 the "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.³¹⁹ 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 included examples of quantitative and qualitative criteria that may signal such significance.

One commenter argued that the proposed presumption regarding deficiencies in the governance and leadership component was unnecessary, on the basis that not every deficiency in governance and leadership was necessarily a major QC deficiency. Other commenters expressed concern that the circumstances presumed to evidence a major QC deficiency remove the auditor's ability to apply professional judgment. Another commenter suggested that the presumptions could be replaced with indicators of a major QC deficiency, similar to how AS 2201 treats material weaknesses. Another commenter stated that it is not appropriate to include in the proposed definition circumstances when a major QC deficiency is presumed to exist because the factors provided in paragraph .78 are sufficient to make the evaluation of whether a QC deficiency is a major QC deficiency. Another commenter suggested that these presumed major QC deficiencies could be relocated from the definition and into paragraph .78 and achieve the same objective.

We considered the commenter feedback. However, as described above, we continue to believe that because of the pervasive impact of leadership and the "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—that is, would almost always result in a major QC deficiency.

We also note that, consistent with the proposal, the presumptions are not conclusive and can be rebutted by the firm in appropriate circumstances. The note to paragraph .78a clarifies that in order to rebut a presumption that a major QC deficiency exists, a firm must demonstrate, by taking into account both of the factors in paragraph .78b. (including all of the listed examples in paragraph .78b.(1)), that a major QC deficiency does not exist.³²⁰ The standard thus allows for circumstances in which a deficiency related to one of the presumptions does not amount to a major QC deficiency, and creates an opportunity for firms to exercise

³¹⁹ See Notes to AS 1220.12, .17, .18B.

³²⁰ When circumstances exist that are presumed to evidence a major QC deficiency, but the firm demonstrates that it does not have a major QC deficiency, the firm will 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. See Appendix 2, Form QC, *Report on the Evaluation of the Firm's System of Quality Control*, Item 2.5.

professional judgment in deciding whether to attempt to rebut the presumption and, if so, how to apply the paragraph .78b factors. However—appropriately, in our view—the presumptions shift the burden of proof to the firm, which will have to demonstrate that circumstances generally reflecting a major QC deficiency do not constitute a major QC deficiency in its case. We believe the term “presumption” achieves this burden shifting more clearly than “indicators” or other terms would do.

We agree with the commenter that suggested that the presumed major QC deficiencies should not be included in the definition of major QC deficiency and have taken another commenter’s suggestion to relocate the presumption to paragraph .78. Accordingly, we have made the following revisions to paragraph .78:

- Relocated the circumstances presumed to evidence a major QC deficiency from the definition into paragraph .78a, so they are explicitly part of the process of determining whether a major QC deficiency exists.
- Included a note to clarify what the firm has to demonstrate in order to rebut the presumption that a major QC deficiency exists.

Importantly, 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.

One firm requested clarification of the relationship between the definitions of “engagement deficiencies” and “significant engagement deficiencies.” As is evident from their respective definitions, significant engagement deficiencies are a subset of engagement deficiencies. QC 1000 defines an engagement deficiency as “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.” As the footnote to paragraph .78 of the standard provides, “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.”

iii. Factors for consideration

To help firms make the determination of whether a major QC deficiency exists, the standard provides factors on which to base the determination, which assist firms in applying the definition. Several commenters expressed general support for the proposed factors, and we are adopting them as proposed.

We did not receive comments on the examples that illustrated the proposed factors, and we are adopting this aspect of the proposal substantially as proposed, with one addition, in a renumbered paragraph .78b.(1)(d). The added example relates to the persistence of an unremediated QC deficiency or combination of unremediated QC deficiencies over time. Through our oversight activities we have observed repeat or persistent criticisms—appearing in consecutive inspections, or occurring consistently over multiple years, even if not every year—which we believe may be indicative of a problem so pervasive and/or so severe that the firm has been unable to effectively remediate it, or of significant failures in the firm’s remediation process. Firms will need to consider whether and how the existence of a persistent unremediated QC deficiency or combination of unremediated QC deficiencies year over year might indicate the existence of a major QC deficiency.

b. The following factors are relevant (i) in rebutting a presumption under paragraph .78a., and (ii) for unremediated *QC deficiencies* that do not give rise to a presumption under paragraph .78a., in determining whether a *major QC deficiency* exists:

- (1) The severity and pervasiveness of the unremediated *QC deficiency* or combination of unremediated *QC deficiencies*, which may be evidenced by, for example:
 - (a) The number of components or *quality objectives* directly or indirectly affected;
 - (b) The extent to which the unremediated *QC deficiency* or combination of unremediated *QC deficiencies* relate to a component, *quality objective*, or *quality response* that affects the design or operation of other aspects of the QC system;
 - (c) The number and pervasiveness of root causes;
 - (d) The persistence of the unremediated *QC deficiency* or combination of unremediated *QC deficiencies* over time;
 - (e) The number of *engagements* that are affected by the unremediated *QC deficiency* or combination of unremediated *QC deficiencies* or are likely to be affected in the future if the *QC deficiencies* are not remediated;
 - (f) The number of *engagements* that may have unsupported opinions unless additional procedures are performed; and
 - (g) 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* or combination of unremediated *QC deficiencies*, the firm would consider both quantitative and qualitative implications.

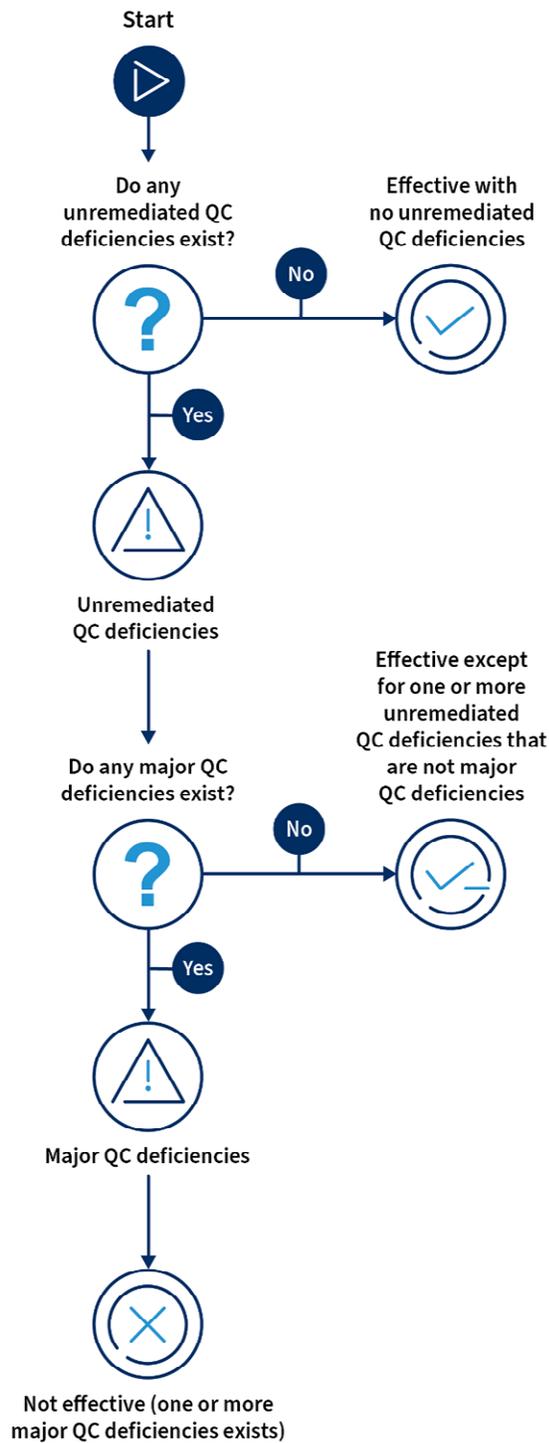
- (2) The extent to which remedial actions have been implemented, tested, and found to be effective.

Under the standard, the factors for determining whether a major QC deficiency exists are:

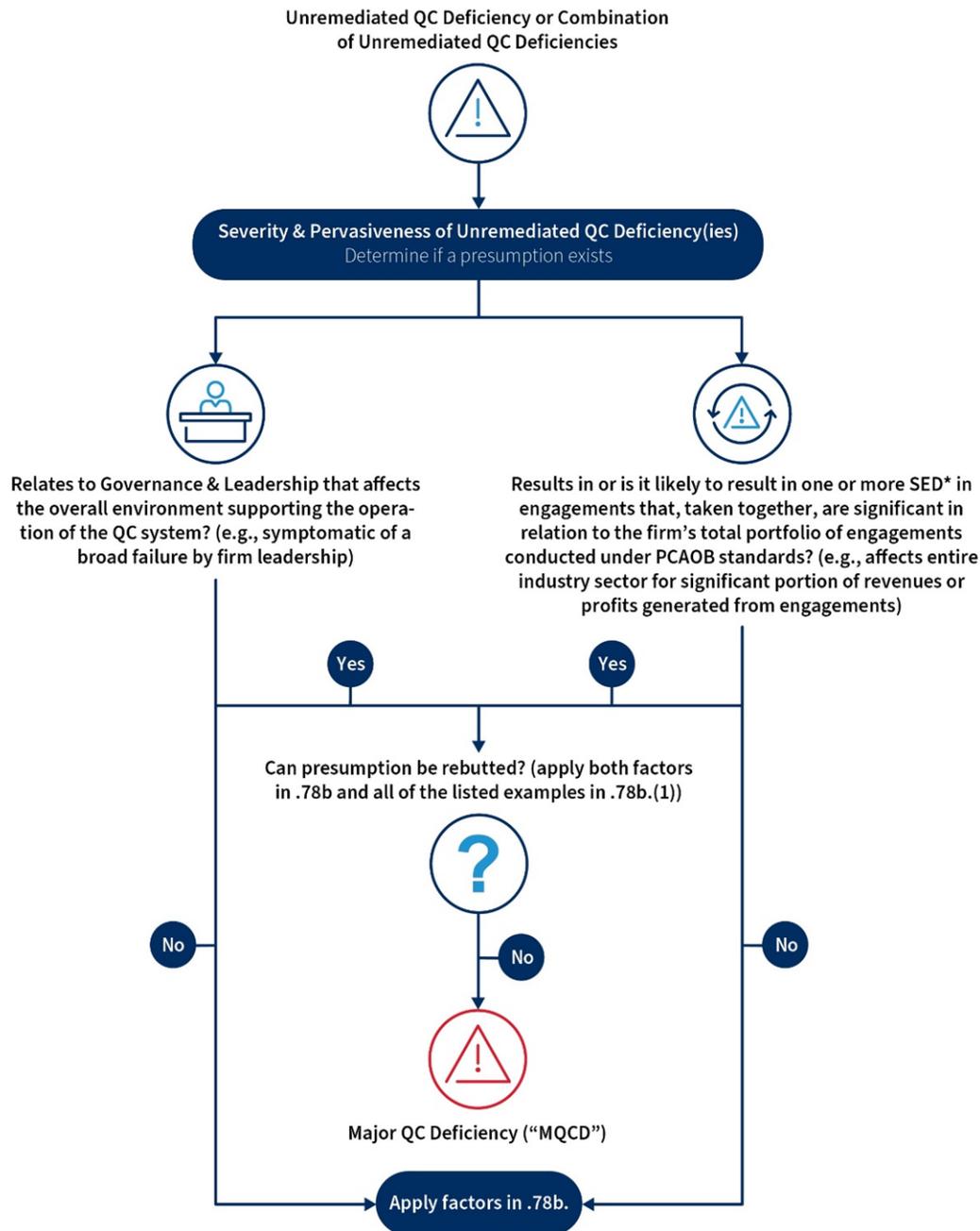
- The severity and pervasiveness of the unremediated QC deficiency or combination of unremediated QC deficiencies. A firm assesses an unremediated QC deficiency, considering both quantitative and qualitative implications. For example, a firm will assess how many of the components of its QC system, quality 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. We view the concepts of severity and pervasiveness as overlapping and the factors in paragraph .78b.(1) that indicate the severity and pervasiveness of an unremediated QC deficiency, or combination of unremediated QC deficiencies, represent both aspects. The standard does not require the firm to determine that an unremediated QC deficiency is both severe and pervasive in order for it to constitute a major QC deficiency, nor is the list of examples exhaustive.
- 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 reduce the severity or pervasiveness 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

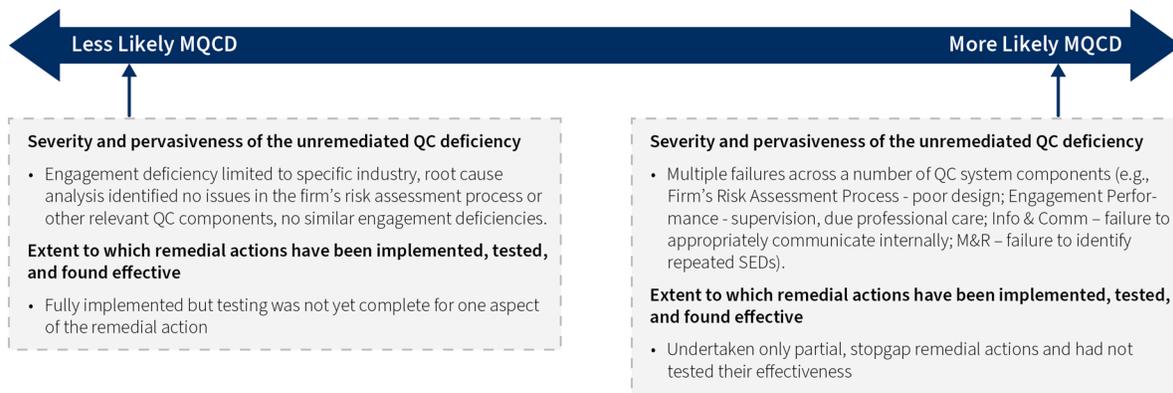


Determine Whether a Major QC Deficiency(ies) Exists



*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.

Example Considerations Relevant to Determining Major QC Deficiency



c. Firm reporting on QC system evaluation

i. 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 November 30.

.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 paragraph .80a.(2) or paragraph .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.

1) Annual reporting

We proposed to require 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. Many commenters supported the proposed annual reporting requirement. However, one commenter stated that this annual firm reporting would be of no meaningful incremental benefit to the PCAOB and has the potential to create an adversarial dynamic that would not promote audit quality or well serve investor protection goals. Another commenter suggested that if the required reporting on Form QC to the PCAOB would lead to follow-on requests from the PCAOB to furnish more detailed information as to specific findings, then confidentiality legislation may be an issue for firms. Other commenters argued that, because the PCAOB could obtain the same information through the inspections process, reporting to the PCAOB would be unnecessarily duplicative. Another commenter argued that all unremediated QC deficiencies should not have to be reported on Form QC, specifically commenting that the PCAOB already has the ability to access QC documentation for all registered firms to view this information. Another commenter suggested that the value of the report when not accompanied by independent attestation is likely to be limited.

We acknowledge that the Board has the ability to request from firms information relating to their QC systems. However, we continue to believe that annual reporting to the Board will provide the PCAOB with important information about firm QC systems in a timely and structured way and will provide an effective and efficient means of gathering information about firm QC systems. Currently, only 14 of the approximately 1,600 registered firms are subject to annual inspection. Approximately 640 registered firms are required to be inspected

on a triennial basis, of which approximately one third are inspected in any given year.³²¹ Therefore, we do not believe that collecting firms' QC information during an inspection would provide timely information regarding the majority of registered firms' QC systems. Data collected by the PCAOB will 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 will 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. We believe that this will help better advance our investor protection mandate. Additionally, we believe that a formal reporting process will result in enhanced accountability of firm leadership for QC and an additional incentive for prompt remediation of identified QC deficiencies. While we are not requiring attestation over the firm's evaluation process, we believe that the requirements regarding the form, including required certifications, will provide sufficient incentive for firms to report accurately and completely (and enforcement remedies will be available if they do not). The incremental effort for a firm to report its evaluation to the PCAOB will not be substantial, as the firm is simply communicating the results of its evaluation process and any related remediation activities, which it is required to conduct and document under QC 1000 in any case.

One firm suggested that the Board only require reporting to the PCAOB if a firm performed engagements in accordance with PCAOB standards during the one-year period ending on the evaluation date. We considered whether this change would be of significant benefit to firms and would further enhance the scalability of the standard. However, firms that are not currently performing engagements may have responsibilities with respect to past engagements.³²² Moreover, regardless of whether they are required to report the results of the annual evaluation, firms will still be required to perform an evaluation pursuant to QC 1000 in such a circumstance. On that basis, we believe that reporting would be valuable even for firms that did not perform an engagement during the year preceding the evaluation date, and that reporting should not constitute an undue burden.

2) Reporting mechanism: Form QC

As proposed and under the final rules, firms are required to report their annual QC evaluation on a new form, Form QC. The text of Form QC, together with the form instructions, is attached as part of Appendix 2. Several commenters supported the use of a separate Form QC, with some of these commenters asserting that because firms should be allowed to select their own evaluation date, this would necessitate the use of Form QC, rather than an existing

³²¹ The data were obtained from Audit Analytics and publicly available data from the PCAOB's Registration, Annual and Special Reporting (RASR) available at <https://rasr.pcaobus.org>.

³²² See, e.g., AS 2901; AS 2905.

form such as Form 2. Another commenter supported the view that expanding Form 2 to incorporate QC information was not favorable as this would make the form longer and more complex. We continue to believe that separate reporting on new Form QC remains appropriate. The contents of Form QC are the result of a separate evaluation process by a firm and we believe that it is simpler for the results of the annual evaluation to be reported on a separate form. In addition, as discussed in more detail in Section IV.L.1.a.ii. above, QC 1000 requires firms to conduct an annual evaluation of their QC system as of September 30. The use of a separate Form QC for reporting the results of the annual evaluation will facilitate closer alignment of the timing of the reporting and the annual evaluation date. For example, the submission deadline for Form 2 is June 30, which is nine months after the annual evaluation date of September 30. Furthermore, Form 2 reporting is public and, as discussed in more detail in Section IV.L.1.c.ii. below, Form QC will not be publicly available.

The proposal asked whether we should permit proposed Form QC to be filed in XML or another machine-readable format. In response, one commenter supported the PCAOB permitting widely accepted formats that support usability. Another commenter supported that the web-based system for submitting the information be navigable and easy to use. Reporting to the PCAOB will 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).

3) Contents of Form QC

The contents of Form QC will address the matters listed in paragraphs .79-.80. In addition, Form QC will elicit certain information about the firm and the individuals responsible for the QC system, aggregated information about the items required to be reported in 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.).

One firm asserted that the requirement to report unremediated deficiencies is at too granular a level to be meaningful. 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 reporting of the firm's annual evaluation to the PCAOB, as well as potentially affecting the rigor of the firm's evaluation process. As noted above, reporting on all unremediated QC deficiencies will 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 have

decided that annual reporting to the PCAOB of the results of firms' annual evaluation of the QC system, including unremediated QC deficiencies, is the appropriate approach.

One commenter supported the inclusion of Item 4.1 of Form QC on whether the Board should inform a party of a subpoena for information on Form QC, but another commenter argued that it was unnecessary, may interfere with investigations, may create a potential ground for firms to sue the Board in the event notification did not occur, or potentially involve the PCAOB in private litigation. Because Form QC will be nonpublic, we believe that firms should be given the opportunity to request such notification, consistent with our treatment of the other nonpublic form filed with the PCAOB.³²³

An investor suggested firms should also affirm to the PCAOB on Form QC that any information that the firm voluntarily released (e.g., in transparency reports, audit quality reports, and CEO speeches) over the time period covered by Form QC was consistent with the state of their quality control system, as of the time of the voluntary disclosure. This commenter also suggested that the affirmation should be publicly available. An investor-related group suggested that firms should report publicly on Form QC how an independent QC board committee (established under paragraph .28 of QC 1000) carries out its responsibilities. As discussed in more detail in Section IV.L.1.c.ii. below, we are not making any of Form QC publicly available, so there would be no benefit to the public in adding this information to Form QC. However, the Board remains committed to finding additional ways of providing public disclosure to better inform investors about firms, and to that end, we have separately proposed to amend Form 2 to identify whether the firm has an external oversight function for the audit practice (established under paragraph .28 of QC 1000) and, if so, the identity of the person or persons and an explanation for the basis of the firm's determination that each such person is independent (including the criteria used for such determination) and the nature and scope of each such person's responsibilities.³²⁴

Some commenters indicated that there might be circumstances in which information required by Form QC may be restricted from disclosure by the operation of legal requirements (such as data protection laws). Two of these commenters suggested that the instructions to Form QC should include a provision found in other PCAOB forms allowing firms to decline to provide information if the firm believes that providing such information would violate non-U.S. law. Another commenter, while acknowledging that it was not aware of non-U.S. laws that would prohibit reporting the information required on Form QC, suggested that the Board state that firms would not violate the requirement to file Form QC if laws or regulations exist in the jurisdiction(s) of the firm that prevent compliance with this requirement.

³²³ See General Instructions 5 to PCAOB Form 1-WD, *Request for Leave to Withdraw from Registration*.

³²⁴ See PCAOB Rel. No. 2024-003 at 29.

We acknowledge that certain PCAOB forms include a general instruction for assertions of conflicts with non-U.S. law. In these circumstances, the instructions identify the specific parts and items within the form for which the firm may withhold responsive information on the basis that the firm could not provide such information without violating non-U.S. law. Form QC, however, calls for certain discrete information that we do not believe, and that no commenter has suggested, would be restricted from disclosure under non-U.S. law (e.g., the firm's name, the evaluation date, the overall conclusion of the firm's evaluation, the number of unremediated QC deficiencies, and for each unremediated QC deficiency, whether it is or is not major and the areas of the QC system to which it relates). Beyond that, Form QC requires firms to provide narrative information, including a description of each unremediated QC deficiency, the basis for the firm's QC deficiency determination, a summary of remedial actions, and the firm's major QC deficiency presumption analysis (if applicable). We believe that the narrative information required to be reported in Form QC can be provided at a sufficiently summarized level such that the reporting of such information by the firm would not require disclosure of information that could be restricted by legal requirements such as data protection laws. For example, if a firm reports an unremediated QC deficiency on Form QC, we believe that the firm could provide a description of the deficiency and a summary of the remedial actions taken and planned to be taken without violating non-U.S. law.

Some commenters suggested that the standard should clarify that firms submit Form QC in connection with an inspection under Section 104 of the Sarbanes-Oxley Act and that Form QC should receive the same confidentiality protections of Section 105(b)(5)(A) of the Act that other inspections-based documents and information receive. One of these commenters further suggested that the Board should make clear that all of Form QC and its contents benefit from the privilege established by Section 105(b)(5)(A), regardless of how a deficiency has come to light. Another commenter suggested that the Board consider requesting firms to provide the information proposed to be in Form QC through the inspection process, and that such requests could be made at any time to facilitate the PCAOB's inspections. The commenter explained that under this suggested alternative approach, Part II and the related exhibits of Form QC could be removed and instead, the PCAOB could request this as part of the inspection process, to allow the information to be privileged under Section 105(b)(5), while retaining the certification.

We do not believe that it is appropriate to specify that Form QC is provided in connection with an inspection. The obligation to furnish Form QC to the PCAOB does not derive from a request from our inspection staff; instead, that obligation arises expressly from paragraph .79 of QC 1000. And while Form QC, like other forms filed with the PCAOB (such as annual reports on Form 2), may be used to inform our inspection process, that is not the only purpose of the form; it may be used, for example, in connection with our standard-setting processes, our economic and risk analysis, and our registration program, to name a few examples. Furthermore, Form QC submissions may not directly relate to an inspection. For example, triennially inspected firms are required to report on Form QC annually, including in years in which they are not subject to inspection. Firms that are no longer performing

engagements making them subject to PCAOB inspection may still be required to report on Form QC in light of their postissuance QC responsibilities, such as their audit documentation retention obligations under AS 1215. Accordingly, we do not believe that Form QC is received by the Board in connection with an inspection for purposes of Section 105(b)(5)(A) of the Act, though we note, as discussed further in Section IV.L.1.c.ii below, that certain information contained within a Form QC may be subject to the protections of Section 105(b)(5)(A).

4) Reporting date

The proposal contemplated that firms would have until January 15 of the year following the November 30 evaluation date to file Form QC. This provided firms 46 days from the evaluation date to the reporting date. As adopted, the standard provides that firms have until November 30 to report on Form QC to the PCAOB. This provides firms with 61 days after the evaluation date of September 30 to file Form QC. We have added a general instruction to Form QC to clarify the reporting period covered by the firm's evaluation. The reporting period is the period beginning on October 1 of the year preceding the year in which Form QC is required to be filed (or, if a firm's obligation to implement and operate a QC system arises under paragraph .07a after October 1 of that year, the date on which that obligation arises) and ending September 30 of the year Form QC is required to be filed. Under this provision, the reporting period will generally be twelve months long, but will be shorter if the obligation to implement and operate the QC system arises mid-period (whether by virtue of the effective date of QC 1000 or the firm's otherwise becoming subject to the requirement to implement and operate the QC system).

Several commenters suggested a 90-day period from the evaluation date to the reporting date would be appropriate because this would allow for testing of controls that operate at the evaluation date, and allow firms to perform thorough and detailed evaluations. Several commenters suggested that additional time is required for Form QC preparation beyond 45 days to be able to compile relevant information, including information on remedial actions, with some commenters supporting a 60-day period that would align with the shortest due date applicable to issuers to report on their conclusion on internal control over financial reporting. Another commenter suggested that reporting should be in advance of the April/May proxy season, suggesting a reporting date of April 1 using an evaluation date of February 28. One commenter did not support a January 15 reporting deadline, suggesting that this would be close to the conclusion of the audit and, if there are matters to be reported to the audit committee, would leave the audit committee with little time to consider and respond to the information before the due date of the issuer's Form 10-K. The commenter also suggested that for firms subject to both ISQM 1 and QC 1000, having different reporting dates would create unnecessary complexities for audit committees receiving reports under different standards and different points in time. Several commenters suggested that a January 15 reporting deadline would be challenging for many firms given the proximity to year-end holidays. One commenter suggested that coinciding the reporting date of January 15 with the PCAOB's inspection process

should not be a key consideration for firms in determining the most appropriate date for their annual assessment.

We believe that extending the number of days from the evaluation date to the reporting date to 61 days will provide firms sufficient time to complete their evaluation and report to the PCAOB. In addition, the reporting date of November 30 as adopted is prior to the calendar year end and the traditional busy period for many firms, which we believe will further benefit firms in performing their evaluations.

ii. Form QC: not publicly available

The proposed standard contemplated that Form QC would be nonpublic. Many commenters, including firms, supported requiring the contents of Form QC to be nonpublic. One firm commented that to require public reporting would be inconsistent with the balance that Congress struck in Sections 104(g)(2) and 105(b)(5) of Sarbanes-Oxley. One commenter asserted that the PCAOB should not use rulemaking to cause firms to disclose quality control matters that the PCAOB is prohibited by Sarbanes-Oxley from disclosing or cause firms to otherwise disclose information that would be confidential under statute. Another commenter suggested that public disclosure of unremediated QC criticisms could allow companies that have a lower demand for audit quality to select a lower quality auditor.

Other commenters, generally investors and investor-related groups, objected to the lack of public disclosure. Two investors commented that the proposed disclosure to audit committees but not to the public leaves investors in the dark, and that disclosure requirements provide an effective incentive for remediation of identified quality control issues. Another commenter asserted that if the PCAOB is permitted to compel firms to disclose quality control information to audit committees, then they expect that the PCAOB could also compel disclosure of such information to the public. The commenter suggested that QC disclosures only to audit committees may have unintended consequences for the public markets as companies will have more information regarding the quality of their auditors than individual investors. Some investors and investor-related groups commented that the proposal provides little public accountability with no mandated or meaningful disclosures about the operation of the QC system. Two investors and an investor-related group commented that firms furnish a statement of the quality control policies of the firm when registering with the PCAOB, however this information is not required to be updated and can quickly become out of date. Therefore, providing the public with additional disclosure about a firm's quality control system will act as an updating function.

One firm suggested that it would be difficult for the public to synthesize in a useful manner the information in Form QC without the right level of context. However, three investor-related groups did not support the view that partial disclosure of Form QC would result in potentially incomplete or misleading picture of a firm's QC system, and favored disclosing

elements of Form QC and leaving to investors the assessment of the relative importance of the information. One of the investors further suggested a restructuring of Form QC that would allow confidential information to remain confidential while sharing decision-useful information with investors. Another investor suggested that investors would directly benefit from the disclosure of firm-identified deficiencies that omits PCAOB-identified deficiencies, further commenting that to the extent firms do not disclose any deficiencies to the public, investors may have concern that the system of quality control was not sufficient to proactively identify deficiencies.

We continue to 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.³²⁵ 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.³²⁶ Making or requiring public disclosure through a publicly available form of QC deficiencies that have been identified during a PCAOB inspection would be inconsistent with this provision of Sarbanes-Oxley, if disclosure were required before the Board has determined whether it is satisfied with the firm's remediation efforts or after the Board has determined that the firm has satisfactorily addressed the deficiencies.

The limitation imposed by Section 104(g)(2) is 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 Board's remediation determination. However, if information reported by a firm on Form QC informs a QC criticism contained within an inspection report, and if that QC criticism is not addressed to the Board's satisfaction within 12

³²⁵ See QC 1000.71b.

³²⁶ See Section 104(g)(2) of Sarbanes-Oxley, 15 U.S.C. § 7214(g)(2); see also PCAOB Rule 4009.

months of the date of that report, then the QC criticism would be made public in accordance with Section 104(g)(2).

We believe that the omission of deficiencies that are still subject to the Board's remediation determination (or as to which the Board has made a favorable remediation determination) would result in a publicly available Form QC that supplies an incomplete and potentially misleading picture of the effectiveness of the firm's QC system. Our view is guided by the familiar principle that omitting material facts from a disclosure can cause the statements that are made to be misleading.³²⁷ Our decision not to mandate public disclosure of Form QC, in a context where material information (namely, the existence and nature of QC deficiencies that are still subject to the Board's remediation determination) may often be omitted, is motivated in part by that concern, not by any lack of confidence in investors' ability to interpret the information provided to them. For example, a firm may have self-identified a number of relatively minor QC deficiencies in its own evaluation, while QC deficiencies identified by the PCAOB are more severe or could be of greater public interest. In a partial disclosure scenario, the firm would disclose the minor matters, but not the more significant ones that are still subject to the Board's remediation determination, creating a misleading picture of the state of its QC system.

We are also concerned that, in certain circumstances, even such partial disclosure would conflict with Section 104(g)(2) of Sarbanes-Oxley. For example, assume we required firms to disclose the conclusion of their most recent evaluation and any QC deficiencies that were self-identified, but not any PCAOB-identified QC deficiencies that remain subject to the Board's remediation determination. Under such an approach, if a firm had PCAOB-identified QC deficiencies but no additional self-identified QC deficiencies, then the firm would not disclose any specific QC deficiencies but would disclose an overall conclusion (either "effective except for one or more QC deficiencies that are not major QC deficiencies" or "ineffective," depending on the nature of the PCAOB-identified deficiencies) that nonetheless reveals that the firm has unremediated QC deficiencies, without specifically identifying them. In such a scenario, we would be indirectly requiring firms to disclose the existence of PCAOB-identified QC deficiencies that are still subject to the Board's remediation determination, notwithstanding Section 104(g)(2) of Sarbanes-Oxley.

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

³²⁷ See, e.g., SEC Rule 10b-5(b), 17 CFR § 240.10b-5(b).

investigation.³²⁸ Additionally, Form QC requires 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.³²⁹

We also believe that 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 adopting Form QC as a nonpublic form, as proposed.

To that end, we are adopting new PCAOB Rule 2203A, included in Appendix 2, which establishes the Form QC reporting requirement and specifies that the Board will not make a filed Form QC or the contents thereof (including any amendment thereto) public.³³⁰ The rule does not, however, prohibit a firm from voluntarily disclosing its Form QC or the contents thereof to the public or to particular stakeholders. Nor does the rule prohibit us from sharing Form QCs or their contents and related documentation with the SEC or other entities,

³²⁸ See Section 105(b)(5)(A) of Sarbanes-Oxley, 15 U.S.C. § 7215(b)(5)(A).

³²⁹ See Section 102(e) of Sarbanes-Oxley, 15 U.S.C. § 7212(e); PCAOB Rule 2300(b).

³³⁰ 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 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").

consistent with Sarbanes-Oxley.³³¹ The rule expressly provides that Form QCs and their contents may be publicly disclosed in enforcement proceedings.³³²

One commenter noted that Form QC or its contents may not be relevant to all enforcement proceedings and suggested that the Board explicitly clarify in the final standard that the Form QC may become public as part of an enforcement proceeding where Form QC or its content is relevant to the respective enforcement proceeding. We do not believe that such a clarification is necessary. When a Form QC or its content is relevant to an enforcement proceeding, it would be admissible, and when it is not relevant to an enforcement proceeding, our adjudication rules already specify that it shall be excluded.³³³

The 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 are not identified (unless the information has previously been made public by the firm or firms involved or by other lawful means). Two commenters suggested that the Board could publish Form QC information in summaries, compilations, or other general reports, provided that the firms are not identified. However, another commenter did not support aggregated anonymized information and suggested that this would depart from the spirit and letter of the confidentiality provisions of Sarbanes-Oxley. We believe that summaries, compilations, or general reports that present relevant QC-related information on an aggregated and anonymized basis may provide useful insight to investors, audit committees, firms, and other stakeholders about firm QC systems, the implementation of QC 1000, and related matters. We also continue to believe that presenting such data on an aggregated and anonymized basis would not run afoul of any limitations of Sarbanes-Oxley.³³⁴

While firm reporting on Form QC will be nonpublic due to the aforementioned legal constraints and policy considerations, we note that other aspects of our standard promote transparency about firm QC systems within the confines of those constraints. For example, we

³³¹ See, e.g., Section 105(b)(5)(B) of Sarbanes-Oxley, 15 U.S.C. § 7215(b)(5)(B).

³³² On 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.

³³³ See PCAOB Rule 5441, *Evidence: Admissibility*.

³³⁴ For comparison, see PCAOB Rule 4010, *Board Public Reports*, which provides, in pertinent part, that the Board may publish summaries, compilations, or other general reports concerning the findings and results of its inspections, including discussion of QC criticisms or potential QC defects, provided that no such published report shall identify the firm or firms to which such criticisms relate, or at which such defects were found, unless that information has previously been made public in accordance with PCAOB Rule 4009, by the firm or firms involved, or by other lawful means.

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 metrics could also affect what financial statement users demand and what firms could usefully provide. We are requiring that the QC system operate over any public reporting that firms do provide, including any public reporting of metrics. Firms have to establish a specific quality objective with regard to their public reporting, including that any firm-level or engagement-level information with respect to the firm's audit practice, firm personnel, or engagements communicated to external parties be accurate and not misleading, and—as with any quality objective—they have to monitor their performance in relation to that objective and remediate identified deficiencies.

We are also requiring that, as part of their annual reporting on Form 2, all registered firms provide an annual confirmation with regard to the design of their QC system under QC 1000 and whether they were required to implement and operate the QC system. See Section V.C.6 for a discussion of the amendments to Form 2 and Appendix 5 for the text of the amendments. We believe an annual confirmation will 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 will 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 will be publicly available on our website and will be accessible to investors and other financial statement users, audit committees, and other stakeholders. It will also inform our oversight efforts.

To accompany the changes to Form 2, we are also adding a similar confirmation to the application for PCAOB registration, Form 1. We believe such a confirmation will 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.5 for a discussion of the amendments to Form 1 and Appendix 5 for the text of the amendments.

iii. Certification of the evaluation of the firm's QC system by firm leadership

As proposed, we are requiring 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 (the "QC certifiers") certify the firm's report to the PCAOB on the evaluation of its QC system.³³⁵ Several commenters were supportive of the certification requirement, including a commenter that stated that individual certifications are likely to focus the mind and it seems likely that improvements will be seen as a result of such a requirement.

³³⁵ See QC 1000.14d and .15b.

Some commenters opposed the certification requirement, saying it adds little value to the evaluation of the QC system, may not provide a full view of the subject matter it purports to be certifying to and may create an unjust reliance by a third party on the certification, or is an ineffective incentive for making quality control a higher priority within a firm. Another suggested that while certification may sharpen an individual's sense of accountability, this may not necessarily lead to and cannot guarantee enhanced engagement quality. Another commenter suggested that certification requirements could act as a barrier to registration for firms operating in environments in which there are no Sarbanes-Oxley style reporting requirements,³³⁶ and that it could have a disproportionate impact on smaller firms.

We continue to believe that, analogous to the CEO and CFO certifications required under Sarbanes-Oxley, certification of Form QC will lead to increased discipline in the evaluation process and will reinforce the accountability of the certifying individuals, which in turn should improve the quality of the firm's evaluation. The text of the certification, which is unchanged from the proposal, appears in Item 3.2 of Form QC, contained in Appendix 2. That item requires certification of certain information regarding the design and evaluation of a firm's QC system, including that each QC certifier reviewed the Form QC and that the disclosures made in the Form QC are complete and accurate in all material respects to the individual's knowledge.³³⁷

³³⁶ 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).

³³⁷ See e.g., Daniel A. Cohen, Aiyasha Dey, and Thomas Z. Lys, *Corporate Governance Reform and Executive Incentive: Implications for Investments and Risk Taking*, 30 *Contemporary Accounting Research* 1298 (2013) (finding that their sample of firms significantly reduced investments in risky projects in the period following SOX); Hsuihui Chang, Jengfang Chen, Woody M. Liao, and Birendra K. Mishra, *CEOs'/CFOs' Swearing by the Numbers: Does it Impact Share Price of the Firm?*, 81 *The Accounting Review* 22 (2006) (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); Gerald J. Lobo and Jian Zhou, *Did Conservatism in Financial Reporting Increase after the Sarbanes-Oxley Act? Initial Evidence*, 20 *Accounting Horizons* 57 (2006).

As proposed, the final rules require certification from both the individual assigned ultimate responsibility and accountability for the QC system (i.e., the firm's principal executive officer(s)) and the individual assigned operational responsibility and accountability for the QC system. One commenter suggested that certification be required only from the individual with ultimate responsibility and accountability for the firm's QC system on the basis that, in the event of differences of opinion between the two certifiers, the individual responsible for the operational responsibility and accountability for the QC system could be subject to excessive pressure from the firm's principal executive officer. We note that under EI 1000, certifiers will be subject to a duty to act with integrity, which includes not subordinating their professional judgment, and that the individual with ultimate responsibility and accountability for the firm's QC system will have a number of obligations (for example, under QC 1000.14a.) that are inconsistent with the exercise of undue influence over a subordinate.

We are not requiring similar certifications from other personnel in the QC system, but firms may choose to institute policies that require levels of certification internal to the firm to assist those certifying Form QC.

Some commenters raised concerns about the potential liability of the QC certifiers. Several requested clarification on whether the QC certifiers could be held personally liable for an inaccurate statement only if they made the statement knowing it was false or recklessly not knowing it was false. One of these commenters further stated it had concerns about the potential for unnecessary and excessive liability that the certification could impose upon the QC certifiers, and the effect that this could have on firms' ability to recruit qualified professionals to serve. The commenter further suggested that the final adopting release expressly state that while the QC certifiers are responsible for exercising professional competence in connection with the design and operation of the firm's QC system (and may face consequences for failure to do so), the QC certifiers shall not be held responsible for inevitable system errors or the wrongful acts of others which may, in limited circumstances, overcome the best of those efforts.

If a QC certifier fails to certify the firm's Form QC, such conduct would constitute a violation of the individual's obligation under either paragraph .14d or .15b of QC 1000, as applicable to the particular individual. We believe this requirement is important for creating accountability within the firm to achieve the reasonable assurance objective.

Beyond that, QC certifiers' potential liability for statements contained within the Form QC certification is informed by the particular language of those statements. Certain statements in the certification reflect objective facts that we believe are readily knowable by the individual. Paragraph 1 of the certification, for instance, recites that the individual reviewed the firm's report on Form QC. Paragraph 3(a) of the certification contains an acknowledgement that the individual is responsible and accountable for the firm's QC system as a whole and has designed, or caused to be designed, the QC system to ensure that it meets QC 1000's reasonable

assurance objective. Notably, this paragraph is not tantamount to a certification that the firm's QC system in fact meets QC 1000's reasonable assurance objective; on the contrary, Form QC contemplates that a firm might conclude, and report on its certified Form QC, that its QC system is not effective. Rather, in paragraph 3(a), the QC certifiers acknowledge their role in designing (or causing to be designed) the firm's QC system. Paragraph 3(b) of the certification states that the individual evaluated the effectiveness of the firm's QC system and has presented in Form QC the conclusions reached. With respect to each of these statements in the Form QC certification, we believe that the QC certifiers can and should reach a conclusion about their accuracy through the exercise of due professional care. In light of the nature of these statements, we do not agree with the commenters that a showing of recklessness or knowing misconduct is necessary to establish a violation with respect to these aspects of the Form QC certification.

The other statements in the Form QC certification are subject to knowledge qualifiers. In paragraph 2, the QC certifier states that the disclosures made in Part II of Form QC regarding the evaluation of the effectiveness of the firm's system of quality control are complete and accurate in all material respects "[b]ased on my knowledge." Similarly, paragraph 3(c) states that the QC certifier has disclosed, based on the evaluation of the QC system, all unremediated QC deficiencies "of which I am aware." These statements would be inaccurate, and the QC certifier's certification would therefore constitute violative conduct, only if they were knowingly false (if the QC certifier knew that Part II was not complete and accurate in all material respects, or if the QC certifier was aware of undisclosed unremediated QC deficiencies), or if they were made recklessly not knowing they were false.

One commenter suggested that the certification say "to the best of my knowledge" rather than "based on my knowledge," and another commenter suggested that the wording of the certification be updated to "in my capacity as the individual assigned [ultimate/operational] responsibility" rather than "who have been assigned [ultimate/operational] responsibility." After consideration of these comments, we believe that the proposed language is clear, appropriate, and likely to be easily understood, and we do not believe that the proposed certification text requires amending.

One commenter did not support the clause in the proposed certification that states that the firm has disclosed all unremediated quality control deficiencies. The commenter, while acknowledging that this statement is subject to a knowledge qualifier, suggested that this certification could lead to unnecessary disputes over what the QC certifiers should have known in a particular circumstance and suggested that obtaining a certification from the firm (not the individual) may sufficiently address this item without discounting the standards to which auditors are held. As discussed above, the inclusion of "of which I am aware" in paragraph 3(c) of certification means that liability would arise with respect to that paragraph only if the QC certifier made the statement knowing it was false or recklessly not knowing it was false.

Another commenter also suggested that the standards clarify that such certification relates to the “firm’s evaluation” of its QC system, and not a specific individual’s evaluation of the quality management system. As reflected in paragraph .77 of QC 1000, the annual evaluation is conducted by the firm, but the firm, as a legal entity, acts through individuals, and the QC certifiers are the individuals who, under the standard, are responsible and accountable for the QC system as a whole and are required to certify the firm’s report to the PCAOB on its annual evaluation.

Another commenter asserted that the text of the certification suggests that a certifying individual should be considered to have violated QC 1000 only to the extent that the inaccuracy in a submitted certification is material to an investor’s or reasonable auditor’s understanding of the QC system as a whole, and asked that the Board confirm that is the case. We do not agree with this characterization of Form QC. Some statements in Form QC, such as the one in paragraph 2, are expressly conditioned on materiality, while other statements, such as that in paragraph 3(b), are not.

One commenter suggested that creating a potential Sarbanes-Oxley type certification for privately held accounting firms and making this available to the public could create market confusion as to what exactly is being certified and the level of reliance users should place on such a certification. The certification does not contain the outcome of the firm’s annual evaluation of its QC system or identify any unremediated QC deficiencies, but rather certifies the completeness and accuracy of the information being reported to the PCAOB on Form QC. That information is set forth elsewhere in Form QC and, as explained above, we are treating that information as nonpublic. Because we are treating the certified information as nonpublic, we likewise are treating the Item 3.2 certifications as nonpublic; in our view, the certifications do not present a full or useful picture of a firm’s QC system without the underlying information.

[iv. Requirement for Form QC amendments](#)

The proposed general instructions for Form QC included provisions detailing when amendments of Form QC should be filed. Those instructions indicate that Form QC should be amended only to correct information that was incorrect at the time that 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. We have considered commenters’ feedback, and we have retained the language regarding amendments in the proposed general instructions for Form QC, which mirrors the standard for amending certain other PCAOB forms.

Two commenters requested clarification on how firms should consider information that comes to their attention after the evaluation date or the reporting date that is relevant to the firm’s conclusion on Form QC, including how this interacts with relevant provisions in proposed EI 1000. Other commenters suggested that revisions to Form QC not be required for inconsequential matters. Other commenters requested guidance on when an amendment to

Form QC would be required, and some suggested that a threshold be developed for potential amendments.

QC 1000 requires firms to conduct the annual evaluation of their QC system's effectiveness as of September 30 and to file their report on Form QC regarding that evaluation by November 30. Consequently, annual evaluations under QC 1000 should conclude sometime between October 1 and November 30 of each year. Information that relates to the firm's QC system as of the evaluation date (September 30), and that comes to the firm's attention after the evaluation date but before the firm has filed Form QC, should be factored into the firm's evaluation and reflected, if and as appropriate, in Form QC. In contrast, any information that relates to the firm's QC system as of the evaluation date, but that comes to the firm's attention after the firm has filed its Form QC, would not need to be reflected on Form QC or on an amendment to Form QC (although it may constitute a QC observation to be considered in the next annual evaluation of the QC system).

In other words, Form QC captures, and conveys to the Board, the conclusions reached by the firm as a result of its completed annual evaluation, and that evaluation cannot disregard information that comes to light before Form QC has been filed. Therefore, when Form QC is filed, it should be complete and accurate as of the date of its filing. Similar to our guidance on Form 2 reporting,³³⁸ if a firm discovers that it provided incorrect information in a filed Form QC or omitted information that should have been included based on information that the firm was aware of at the time of filing, then the firm should file an amended Form QC. That amendment obligation is not subject to any materiality or other thresholds, because we believe we are entitled to receive Form QCs that contain information that is correct and that do not omit information that was required to be provided. We do not believe that any of the information on Form QC is inconsequential.

v. Reporting to the audit committee

In connection with the proposal of QC 1000, we also proposed amendments to AS 1301, *Communications with Audit Committees*, which contemplated communication to the audit committee of certain information about the firm's most recent evaluation of its QC system. Several commenters supported the amendments as proposed. Other commenters supported limiting the communications to the conclusion of the annual evaluation or limiting communication of deficiencies to only major QC deficiencies. One commenter expressed concern with reporting to audit committees about all unremediated QC deficiencies that exist as of the evaluation date, in part because of the interaction of such communications with the confidentiality restrictions under Section 105(b)(5)(A) of Sarbanes-Oxley. The commenter

³³⁸ See Staff Questions and Answers Annual Reporting on Form 2, at Q34, available at https://assets.pcaobus.org/pcaob-dev/docs/default-source/registration/rasr/documents/staff_qa-annual_reporting.pdf?sfvrsn=5e7259ff_0.

further suggested that requiring all QC deficiencies to be communicated would create more extensive communication requirements for firms related to QC deficiencies than what auditors are required to communicate to audit committees in an audit of ICFR, and in addition, this approach would differ from management's external reporting on its ICFR to its stakeholders, which solely discloses deficiencies that are material weaknesses.

One commenter asserted that audit committees are likely to find more value in understanding quality matters specific to the engagement and having a broader dialogue about the firm's approach to quality control. Two commenters argued that a firmwide report on audit quality would have little utility to each individual audit committee. One of these commenters suggested instead that audit committees would be more influenced by an independent verification of the QC system such as the PCAOB inspection report on their auditor, and information relating to the auditor's performance on their engagement, including audit quality indicators. The other commenter recommended that firms report relevant human resource metrics to the audit committee and explain what was done to assure audit quality was not compromised. One commenter asserted it could be extremely challenging for audit committees to understand and reconcile the information that would be communicated to them under the proposed changes to AS 1301, especially given the considerable time period between the issuance of public portions of firm inspection reports and the potential release of nonpublic inspection findings. One commenter did not support the requirement to disclose a firm's QC deficiencies to audit committees, and stated that QC deficiencies may have little to no impact on a given reporting issuer's audit or that area of the firm's practice. Another commenter questioned whether or not the audit committee would be inclined to seek a new auditor based only on a firm-wide evaluation of quality control furnished to the audit committee by the auditor. One commenter was generally supportive of the requirements but expressed concern with the timing of the required communication due to existing important year-end communications. The commenter expressed concern that not communicating QC deficiencies known at a January 15 reporting date could potentially introduce legal considerations that could place tension on the engagement team and the firm's obligation to comply with other existing required communications under AS 1301. One commenter recommended specifying that this communication is not required to be in writing due to confidentiality concerns, and two commenters did not support any required communication of the annual evaluation of the QC system to the audit committee.

One commenter asserted that requiring firms to communicate to audit committees about their most recent annual QC evaluations is inconsistent with the Congressional balance struck in Sarbanes-Oxley Section 104(g)(2). In addition, the commenter suggested that the requirement indirectly regulates the actions of audit committees and imposes a fiduciary duty of care on audit committees, regardless of whether quality control issues relate to the performance of the engagement, which is beyond the scope of the PCAOB's jurisdiction. Another commenter asserted that the proposed communication could also be construed as contradictory to the PCAOB's conclusion that Form QC would be treated as nonpublic.

Several commenters were concerned about the proposed requirement to discuss remedial actions taken and to be taken, and suggested that some of this information may be protected by Section 104(g)(2) or Section 105(b)(5)(A) of Sarbanes-Oxley. One commenter suggested that the communication of a brief overview of remedial actions taken or to be taken should only be required upon the determination that substantial good faith progress has not been made on the remedial actions.

After consideration of the comments received, we have determined not to adopt the proposed amendments to AS 1301. Although we continue to believe that firms could communicate the overall conclusion of their annual evaluation and their planned remedial actions to audit committees without expressly disclosing information subject to Section 104(g)(2) or Section 105(b)(5)(A) of Sarbanes-Oxley, we recognize that such a disclosure obligation could present implementation challenges. Specifically, and as discussed in more detail in Section IV.L.1.c.ii., there may be challenges associated with compelling firms to publicly disclose certain information about their QC systems while simultaneously preserving their ability not to disclose other related information that may be subject to confidentiality protections, privileges, or prescribed disclosure procedures under Sarbanes-Oxley. We believe that the same challenges could arise if we were to compel firms to make disclosures to audit committees.

We also recognize that firms and audit committees have direct interaction, so while we are not requiring firms to make disclosures to audit committees, an audit committee may ask a firm to voluntarily disclose information about its QC system. As the Board has previously noted, such inquiries could include requesting the firm to keep the audit committee apprised of the status of the quality control remediation process (including whether the firm made a submission to the Board responding to inspection report quality control criticisms by the 12-month deadline) and whether the Board has made a final remediation determination (including a negative determination that has not yet become public).³³⁹

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.

³³⁹ See *Information for Audit Committees about the PCAOB Inspection Process*, PCAOB Rel. No. 2012-003, at 11 (Aug. 1, 2012), available at https://pcaobus.org/Inspections/Documents/Inspection_Information_for_Audit_Committees.pdf.

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.³⁴⁰

Through our oversight activities, we have observed that the nature and extent of firms' documentation of their QC systems vary 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. QC 1000 establishes more comprehensive requirements for firms to document their QC systems.

1. 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 proposal included an overarching documentation requirement that captured the design, implementation, and operation of the firm's QC system and the annual evaluation of the QC system. The scope of that requirement was then specified in proposed paragraphs .82 and .83.

The documentation of the design and implementation of the QC system captures decisions made regarding "the who, what, when, where, why, and how" of the QC system. This aspect of documentation will help firm personnel and others understand what is expected of them in fulfilling their responsibilities and support 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

³⁴⁰ See, e.g., QC 20.21, .24-.25.

triggered, and why certain actions are necessary.³⁴¹ Such documentation will 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 enables the firm to determine if the policies and procedures were operated in the manner that the firm intended.³⁴² It would also provide evidence of compliance with the specified quality responses and other 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 engagements³⁴³ and whether the quality responses implemented by the firm operated as designed.

We received no comments on the general obligation to prepare and retain documentation regarding the QC system and paragraph .81 is adopted as proposed. Below, in connection with paragraphs .82 and .83, we address the comments that we received regarding the scope of the proposed documentation requirement.

- .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, as required by paragraph .27.
 - 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 a network;

³⁴¹ See, e.g., QC 1000.33-.34.

³⁴² Firms that are not required to implement and operate their QC system would not be expected to have anything to document with respect to the operation of the QC system.

³⁴³ See, e.g., QC 1000.55-.57.

- (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 observations* 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 proposal included a list of specific matters that firms would be required to document. Documentation of the lines of responsibilities and supervision within the QC system should reduce operational ambiguity and provide clarity about who within the firm is accountable for various firm supervisory responsibilities within the firm's QC system. One firm suggested that the phrase "successive senior levels" may not be clear. As discussed in more detail in Section IV.E above, under QC 1000.27, 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)—within the QC environment. A description of these successive lines of responsibility and supervision must be included in the documentation of the QC system, and we have added a reference to paragraph .27 to clarify that point.

The requirement for the firm to document aspects of its risk assessment process ensures that the firm will have adequate evidence to support its annual risk assessment. Specifically, the firm is required to document identified quality risks, reasons these risks were identified, and policies and procedures the firm had put in place in response. This documentation is valuable in subsequent risk assessments and could help to support decisions about, for example, whether to establish additional quality objectives, identify new or modified quality risks, or design and implement new quality responses.

The requirements for the firm to document aspects of its monitoring and remediation process will also support 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 standard for the monitoring and remediation process component. This documentation will 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 standard also requires 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 provides 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 and in establishing compliance with the firm's reporting obligations to the PCAOB.

The standard requires 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 standard requires the firm to document how the resources or services are developed and maintained and, if such services or resources were supplemented or adapted, how and why they were supplemented or adapted. Firms will also have to document how the resources or services were implemented and operated. Documentation of such matters will serve as 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 the firm. 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.

As discussed above, we have added a reference to paragraph .27 within paragraph .82a. to clarify that a description of the successive lines of responsibility and supervision must be

included in the documentation of the QC system. Paragraph .82 is otherwise adopted as proposed.

.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 the design, implementation, and operation of the QC system, 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.*

Note: With respect to the operation of the QC system, the documentation must include documentation that enables an experienced auditor to evaluate the operation of the *quality responses*.

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, will help to clarify the firm's expectations of its personnel and promote consistent compliance with the firm's QC policies and procedures.

One firm expressed concern that this "consistent understanding" threshold may not be easily understood. We believe that firms will be able to determine the nature and extent of the documentation needed to facilitate a consistent understanding by firm personnel based on the functioning of their QC system. Based on the requirements in paragraph .83a, firms would initially determine the appropriate level of detail of documentation based on the experience they already have in implementing and operating a QC system under current standards and whether their personnel understand their roles and responsibilities, and modify documentation as needed over time based on their monitoring and remediation activities and the results of their QC system evaluations.

As described previously, documentation supports a firm's QC 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.

In particular, we believe that appropriate documentation of the QC system is necessary for the PCAOB to fulfill our statutory mandate to protect investors and the public interest. Sarbanes-Oxley requires that, in conducting an inspection of a registered public accounting firm, we evaluate the sufficiency of the quality control system of the firm and the manner of the documentation and communication of that system by the firm.³⁴⁴ Sarbanes-Oxley further authorizes us to perform such other testing of quality control procedures as are necessary or appropriate in light of the purpose of the inspection and the responsibilities of the Board.³⁴⁵ In addition, the Board's rules provide that a regular inspection will include, but is not limited to, the steps and procedures as specified in Sections 104(d)(1) and (2) of Sarbanes-Oxley and any other tests of the audit, supervisory, and quality control procedures of the firm as the Director of the Division of Registration and Inspections or the Board determines appropriate.³⁴⁶ As part of the Board's inspection procedures, firms will be expected to provide the PCAOB with evidence relating to the effectiveness of the QC system.

Given that mandate, the level of documentation that would be sufficient to enable PCAOB inspectors to evaluate the effectiveness of a firm's QC system through an inspection may be different from the level of documentation that would be sufficient for the firm to support its annual evaluation. Under QC 1000, a firm must evaluate the effectiveness of its QC system based on the results of its monitoring and remediation activities,³⁴⁷ and firms can determine the nature, timing, and extent of QC system-level monitoring activities taking into account a number of factors.³⁴⁸ There could be certain quality responses, or certain instances of the operation of quality responses, that are not monitored by the firm within a given year and not considered in connection with the firm's annual evaluation. If the firm were required to prepare and retain documentation only to the extent related to its own annual evaluation, the firm might not prepare and retain documentation to evidence that these quality responses operated effectively. However, in light of the scope of our statutory mandate, the Board's inspection procedures cannot be limited to quality responses (and, to the extent applicable, samples of the operation of quality responses) that the firm chose to monitor in the period. On the contrary, firms will be expected to provide evidence of the operating effectiveness of any quality responses selected for inspection in connection with the PCAOB's evaluation of the effectiveness of the firm's QC system.

³⁴⁴ See Section 104(d)(2) of Sarbanes-Oxley, 15 U.S.C § 7214(d)(2).

³⁴⁵ See Section 104(d)(3) of Sarbanes-Oxley, 15 U.S.C § 7214(d)(3); see also Rule 4001, *Regular Inspections*.

³⁴⁶ See Rule 4001, *Regular Inspections*.

³⁴⁷ See QC 1000.77.

³⁴⁸ See QC 1000.65.

Therefore, the proposed standard contemplated that, in order to effectively support the firm's QC system, the documentation of the QC system needs to be at the level of detail to 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 the design, implementation, and operation of the QC system, including the quality objectives, quality risks, quality responses, monitoring activities, remedial actions, and basis for the firm's conclusions reached in the evaluation of the QC system ("experienced auditor threshold"). Incorporating the experienced auditor threshold when describing the extent of detail firms are required to document and maintain regarding their QC system is appropriate because that level of detail will facilitate the firm's monitoring activities and external monitoring, including PCAOB inspections conducted in accordance with Sarbanes-Oxley. Two firms agreed that the experienced auditor threshold was appropriate.

Several commenters, including firms and a related group, argued that the proposed documentation requirements were too broad, and suggested a variety of different limitations to narrow their scope. Some firms suggested that the standard differentiate data relating to the operation of the QC system from data relating to the design, implementation, and annual evaluation of the QC system, with a shorter retention period for the former. Other commenters, including firms and a related group, recommended that the documentation requirements be comparable to the documentation requirements that Sarbanes-Oxley imposes on issuers with regard to management's assessment of the effectiveness of the issuer's internal control over financial reporting.³⁴⁹ Another firm suggested that the documentation requirements be comparable and analogous to the documentation retention requirements set out in the SEC's rules for issuer audits and related interpretive guidance.³⁵⁰ One firm and a related group suggested that the documentation requirements be limited to the evidence to support the annual evaluation of the QC system and related monitoring. Two firms suggested that additional guidance or clarity would be necessary in order for firms to appropriately adopt documentation retention policies related to the operation of controls that meet the expectations of the proposed standard.

³⁴⁹ See Regulation S-K, Item 308, 17 CFR § 229.308 (requiring issuers to maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of ICFR).

³⁵⁰ See Regulation S-X Rule 2-06(a), 17 CFR § 210.2-06(a) (requiring, for audits or reviews of an issuer's financial statements, retention of records relevant to the audit or review, including workpapers and other documents that form the basis of the audit or review, and memoranda, correspondence, communications, other documents, and records (including electronic records), which:

- (1) Are created, sent or received in connection with the audit or review, and
- (2) Contain conclusions, opinions, analyses, or financial data related to the audit or review).

We do not believe that any of the more narrowly scoped documentation requirements suggested by commenters would be appropriate. QC 1000's documentation requirements need to be aligned with our mandate, provided by Congress, to "evaluate the sufficiency of the quality control system of a firm" through our inspection procedures.³⁵¹ Therefore, we believe that it is imperative that documentation that enables the experienced auditor to evaluate the operation of the quality responses should be included in the documentation that is prepared and retained by the firm.

To clarify the level of detail of the documentation relating to the operation of the QC system that is to be prepared and retained under QC 1000, we have revised paragraph .83 to include a note to .83b. stating that with respect to the operation of the QC system, the documentation must include documentation that enables the experienced auditor to evaluate the operation of the quality responses. As discussed in connection with paragraph .86 below, we continue to believe that all of the documentation required under the standard should be retained for seven years.

Commenters also expressed concern that firms would be required to retain large volumes of documentation. Several commenters suggested that the costs associated with retaining documentation of the operation of the QC system would be burdensome, and some further commented that the data relating to the operation of the QC system could include sensitive data, and a requirement to prepare and retain all such data could also introduce heightened data security risks. One firm suggested the Board consider adding language that appears in SQMS 1 clarifying which matters require documentation, specifically referencing SQMS 1 paragraphs A224 and A227.³⁵²

In considering commenters' concerns that the documentation to support that the quality responses operated effectively in every instance would result in a substantial volume of documentation, we believe that the ability to effectively monitor whether the firm's quality responses are properly designed and operating effectively should not be restricted by the

³⁵¹ See Section 104(d)(2) of Sarbanes-Oxley, 15 U.S.C § 7214(d)(2).

³⁵² Paragraph A224 of SQMS 1 states that it is neither necessary nor practicable for the firm to document every matter considered, or judgment made, about its system of quality management. Furthermore, compliance with this SQMS may be evidenced by the firm through its information and communication component, documents or other written materials, or IT applications that are integral to the components of the system of quality management. Paragraph A227 of SQMS 1 states that the firm is not required to document the consideration of every condition, event, circumstance, action, or inaction for each quality objective or each risk that may give rise to a quality risk. However, in documenting the quality risks and how the firm's responses address the quality risks, the firm may document the reasons for the assessment given to the quality risks (that is, the considered occurrence and effect on the achievement of one or more quality objectives) to support the consistent implementation and operation of the responses.

documentation requirements of the standard. Furthermore, we believe that the new note to paragraph .83b clarifies that the firm need not prepare and retain excessively voluminous documentation of the day-to-day operation of every action of its QC system, provided the information is not required to satisfy the requirements of paragraphs .82-.83.

We believe that the extent of documentation sufficient to evidence whether the quality responses operated effectively would scale with the size of the firm's PCAOB practice and the risks and complexities of their engagements and, in turn, the assessed quality risks and the quality responses established to address them. Therefore, the documentation requirements of the standard should be less costly and burdensome for firms with smaller PCAOB audit practices, which we believe is appropriate.

In addition, firms are able to evaluate the nature and extent of the documentation that is necessary to evidence the operation of the quality responses. In determining the sufficiency of the detail and extent of the QC documentation, the firm may identify quality responses for which the evidence required to be able to demonstrate that the quality response operated effectively may not entail retention of all the information produced in the day-to-day operation of the QC system. For example, in the event that a large volume of automated emails sent by the firm to its employees are evidence supporting that a quality response operated, the firm could evaluate whether alternative evidence (such as email delivery reports or other aggregated data) would provide sufficient support regarding the operation of the quality response—without having to prepare and retain all of the individual emails within the QC documentation. In addition, to the extent that the operation of the firm's QC system includes sensitive data, the firm has flexibility to not include the sensitive data fields in the documentation that is prepared and retained to the extent that they are not necessary to evidence that the quality response operated effectively. Furthermore, informed by our oversight activities, we have observed that firms currently archive and retain documentation for extended periods of time and are able to implement processes to appropriately safeguard the information. We have also observed instances where firms have migrated systems and still maintained the appropriate documentation through archives or through migration of the information onto the new systems.

As the note to paragraph .83b makes clear, documentation of every aspect of the operation of the firm's QC system may not be required to evidence that each quality response operated effectively. For example, there may be certain documentation, such as emails or meeting invitations that are sent as part of the day-to-day operation of the QC system, that may not be necessary to enable an experienced auditor to evaluate the effective operation of the quality responses. In these circumstances, the firm may determine it is not required to prepare and retain this information within the documentation of its QC system. However, we also believe that there may be circumstances in which an email or meeting invitation needs to be retained because it evidences how a quality response operated to address a quality risk and

is necessary to enable an experienced auditor to evaluate the operation of the quality response.

Although some commenters suggested the documentation requirements be analogous to the SEC's ICFR documentation retention guidance, we do not believe that is an appropriate threshold. The SEC's guidance indicates that management's documentation needs to provide "reasonable support" for its ICFR assessment and that management's documentation need not include all controls that exist within a process that impacts financial reporting, but should be focused on those controls that management concludes are adequate to address the financial reporting risks.³⁵³ QC 1000 is not a "reasonable support" standard and instead requires documentation to understand how the firm's quality responses are designed to address the quality risks and evidence the operation of the QC system.

The standard's approach to documentation requirements is principles-based and provides for scalability. When determining the form, content, and extent of documentation, the firm will 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), subject to the requirement of paragraph .83 that the documentation be in sufficient detail to support a consistent understanding of the QC system by firm personnel and for an experienced auditor to understand the design, implementation, and operation of the QC system. 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 and that providing specific guidelines and detailed examples of various types of documentation would potentially limit firms' flexibility unnecessarily.

.84 A complete and final set of documentation as required by paragraphs .81-.83 with respect to the 12-month period ended the prior September 30 and any evaluation required

³⁵³ 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 Rel. No. 33-8810 (June 27, 2007), available at <https://www.sec.gov/files/rules/interp/2007/33-8810.pdf>

as of that date should be assembled for retention not later than December 14 (“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.

The proposal contemplated that firms would have to concurrently file their Form QC and assemble their documentation for retention by the same date. As adopted, the standard provides that firms have an additional 14 days after the date that the firm is required to file Form QC to assemble their documentation. Several commenters expressed concern with having the QC documentation completion date be concurrent with the date that the firm must report annually to the PCAOB on Form QC pursuant to paragraph .79. Many of these commenters recommended a document completion date 45 days after the reporting date, with some of these commenters suggesting that 45 days would ensure consistency with the requirements of AS 1215. One firm suggested that a full 45 days to assemble a complete and final set of documentation was not necessary, but the time period needed to assemble documentation should be built into an evaluation of the length of the reporting period if the final standard retained a document completion date concurrent to the reporting date.

After consideration of the comments received, we revised paragraph .84 to provide firms up until December 14 (a total of 75 days after the evaluation date) to complete a final set of QC documentation. This includes an additional 14 days after the date that the firm is required to report to the PCAOB on Form QC. The 14-day period aligns with the changes to our requirements for engagement documentation.³⁵⁴ We believe that larger PCAOB audit practices with more complex and scaled up QC systems will employ the use of electronic tools in the assembly of the documentation of the QC system, and therefore a 14-day period to the QC documentation completion date is feasible. In addition, for smaller PCAOB audit practices with scaled down QC systems, we expect that the volume of documentation to be assembled will be smaller such that a 14-day period is also feasible for those firms. Furthermore, we note that, because the final rule includes a longer period from evaluation date to reporting date than proposed, under the final standard firms will have 75 days after the evaluation date to assemble their documentation, rather than 45 days as proposed.

³⁵⁴ Amendments to the engagement documentation requirements in AS 1215 are addressed in a separate release. See Auditor Responsibilities Release.

The 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 standard requires 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 standard also requires all previously retained documentation supporting the firm's evaluation of its QC system to remain intact and not be discarded.

.86 The firm must retain the documentation of its QC system required under paragraphs .81-.83 and paragraph .85 for seven years from the QC documentation completion date, unless a longer period of time is required by law.

The proposed standard contemplated that the firm would retain QC documentation for seven years from the QC documentation completion date, unless a longer period is required by law.

Two firms commented that they believed the seven-year retention period to be cost-prohibitive. One of these firms commented that if the firm changed its systems, for example, it will have to maintain additional licenses for old systems to access and use the data and pay for up to seven years' worth of storage, and it believes that maintaining that much data would introduce unnecessary cost as well as increased cybersecurity risk. The firm also commented that the seven-year retention period goes beyond the retention requirements of the quality management standards set forth by the AICPA³⁵⁵ and IAASB,³⁵⁶ and that this difference could cause operational challenges. The firm recommended aligning the documentation requirements with the firm's inspection and remediation cycle or allowing the firm to use a risk-based approach based on its judgment. Two firms opposed the seven-year period and suggested that it be based on the most recent inspection (for example, one year from the most recent inspection period), or until the inspection for a particular period has been completed.

As discussed in the proposal, we are 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

³⁵⁵ SQMS 1 requires the firm to establish a period of time for the retention of documentation for the system of quality management that is sufficient to enable the firm and its peer reviewer 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 61. Of SQMS 1.

³⁵⁶ ISQM 1 requires the firm to establish a period of time for the retention of documentation for the system of quality management 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.

providing evidence for inspection purposes or enabling proper remediation. As described in the proposal, we believe that 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. One firm commented on these purposes and suggested that firms should determine what documentation has continuing relevance based on the circumstances. Another firm suggested that this could be reasonably handled by firms on a case-by-case basis, and any necessary documentation that could impact or inform future periods could be specifically retained. The firm further commented that some information would become stale over time and that it does not anticipate information retained early on being used for training or the retention of organizational knowledge in later years. A firm and a related group commented that a seven-year retention requirement is appropriate as it pertains to documentation that supports a firm's evaluation of its system of quality control and the related testing.

After consideration of the comments received, together with the amendment made to paragraph .83. of the standard, we have adopted the requirement to retain documentation for seven years from the QC documentation completion date, unless a longer period of time is required by law, as proposed. We amended paragraph .86 to clarify that the documentation to be retained for this period is the documentation of its QC system required under paragraphs .81-.83 and paragraph .85. This requirement aligns the QC document retention requirement with other requirements in PCAOB standards and SEC rules (such as Regulation S-X Rule 2-06). Furthermore, the documentation relating to the firm's engagements must be retained for seven years,³⁵⁷ and we believe that it is appropriate for the firm to also retain documentation of the QC system that operated over those engagements for the same time period. For consistency and practical application, the retention period is the same for all firms and applies to all documentation the firm is required to accumulate to meet the documentation requirements of the standard.

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.³⁵⁸
- The form, content, and extent of documentation depends on relevant factors, including the size, structure, and nature of the firm's practice.³⁵⁹

³⁵⁷ See AS 1215.14

³⁵⁸ See QC 20.21.

³⁵⁹ See QC 20.24-.25.

- A firm should prepare appropriate documentation to demonstrate compliance with its policies and procedures for the QC system.³⁶⁰
- 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.³⁶¹

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.³⁶²

V. ADDITIONAL AMENDMENTS

QC 1000 supersedes 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. We are rescinding Rule 3400T. In consequence, the interim quality control standards referenced in Rule 3400T are no longer part of PCAOB standards. Rule 3400T is replaced with Rule 3400, which describes the auditor’s responsibilities for complying with quality control standards adopted by the Board and approved by the SEC.

Other amendments to PCAOB standards, rules, and forms are described below.

A. *Amendments to AS 2901, Consideration of Omitted Procedures After the Report Date, and Related 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

³⁶⁰ See QC 20.25.

³⁶¹ See QC 20.25.

³⁶² See, e.g., QC 30.08; SECPS §§ 1000.08(m), 1000.45, 1000.46, 8000.

is no indication that the financial statements are not fairly presented.³⁶³ Existing AS 2901 requires remedial action if (i) 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. Existing AS 2901 does not apply to ICFR audits or to attestation engagements.

2. Amendments to AS 2901

We believe that amendments to AS 2901 are appropriate to modernize the standard, incorporate the concepts and terminology introduced in QC 1000, and bring the standard into alignment with the auditor's existing responsibility to obtain sufficient appropriate audit evidence to support the opinion. The amendments to AS 2901 are set forth in Appendix 3.

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 firm personnel with respect to an engagement of another firm. For an engagement deficiency related to a completed engagement, QC 1000 requires firms to take action to address the engagement deficiency "in accordance with applicable professional and legal requirements" (e.g., AS 2901, AS 2905, AS 2201.98-.99).

We are broadening the scope of AS 2901 to incorporate this new terminology, so that remedial action is required for engagement deficiencies for both financial statement audits and ICFR audits unless it was probable that the engagement report is not being relied upon.³⁶⁴ Reflecting this broader scope, we are also changing 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: In the absence of circumstances indicating that reliance is impossible or unreasonable (e.g., cessation of a trading market for issuer securities),

³⁶³ 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.

³⁶⁴ See QC 1000.68b.

inclusion of an auditor's report (either directly or through incorporation by reference) in the most recent filing on an SEC form that requires inclusion of such an auditor's report evidences that the report is being relied upon.

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.

i. Engagements covered

Existing AS 2901 predates ICFR audit requirements and applies only to financial statement audits. We proposed to extend the scope of AS 2901 to cover engagement deficiencies in ICFR audits as well. Several commenters, generally firms, agreed with the proposal to extend the scope of AS 2901 to include engagement deficiencies in ICFR audits, and we are adopting that change in scope.

Similar to the concept in existing AS 2901, we proposed that the revised standard would not apply to engagements where it is probable that the audit report is not being relied upon.³⁶⁵ The proposed standard included a note providing 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. One commenter pointed out that the use of the term "must" in the proposed note did not allow for the auditor to take into account situations that may indicate an auditor's report is not being relied upon even when the auditor's report is included in the most recent filing on an SEC form. Two commenters suggested that the standard should also exclude engagements where the issuance of the subsequent year's auditor's report is imminent.

³⁶⁵ 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 final standard, 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.

We agree that the standard should allow for circumstances where the auditor's report is included in the most recent filing on an SEC report, but the auditor may nonetheless conclude that the auditor's report is no longer being relied upon. However, in our view, the fact that the issuance of the subsequent year's auditor's report is imminent is not determinative of whether the report continues to be relied upon.

We have revised the note to paragraph .01 to provide that, in the absence of circumstances indicating that reliance is impossible or unreasonable (e.g., cessation of a trading market for issuer securities), inclusion of an auditor's report in the most recent filing on an SEC form that requires inclusion of such an auditor's report evidences that the report is being relied upon. We believe this is responsive to commenter concerns and allows for sufficient flexibility. We have also revised the note to clarify that an auditor's report can be included in an SEC filing either directly or through incorporation by reference.

The determination that an auditor's report is not being relied upon would primarily be influenced by whether the auditor's report and related financial statements are readily available and whether a trading market exists for the company's securities. Circumstances that may suggest the engagement 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 or gone into liquidation.

ii. [Compliance with AS 2905/AS 2201.98](#)

Under the amendments, AS 2901 points the auditor to AS 2905 or AS 2201.98 to the extent they apply. This preserves 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](#)

Existing AS 2901 applies when the auditor concludes that procedures considered necessary at the time of the audit in the circumstances then existing were omitted. As proposed, we are extending AS 2901 to cover all engagement deficiencies identified. We believe it is more consistent with the basic philosophy of QC 1000 and better supports the ultimate goal of improving audit quality to require remedial action for all engagement deficiencies, regardless of whether the audit opinion is unsupported.

b. Activities to address engagement deficiencies

AS 2901 currently requires remedial action 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.

Under the proposal, remedial action would be required for all engagement deficiencies—both those engagement deficiencies that affect the auditor's opinion and those that do not. Many commenters expressed concern with the proposal to require remedial actions for all engagement deficiencies, with one commenter suggesting that remedial actions should only be required for major deficiencies, and another commenter suggesting that the need for remedial actions should be assessed on a case-by-case basis, taking into account the severity of the engagement deficiency. Several commenters suggested that firms should be able to exercise judgment about whether remediation is necessary and observed that in practice most identified engagement deficiencies are remediated. Other commenters considered the proposed requirement overly prescriptive and one commenter suggested that the requirement was unnecessarily burdensome for instances where the auditor's report is adequately supported despite an identified engagement deficiency. On the other hand, two commenters expressed support for the Board's approach to the obligation to remediate engagement deficiencies, with one commenter stating that requiring remedial action for all identified engagement deficiencies, not just in situations where the auditor's opinion may be unsupported, would contribute to improving audit quality.

We continue to believe that requiring firms to take action to address all engagement deficiencies, whether related to an unsupported auditor's opinion or not, is appropriate and reinforces a firm's obligation to comply with all applicable professional and legal requirements, and have adopted this requirement as proposed. As discussed below, when the opinion is appropriately supported, the firm may determine which actions to take in response to an engagement deficiency.

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:

- a. The auditor should perform procedures to obtain additional evidence, to the extent necessary, such that the opinion is supported by sufficient appropriate evidence; or
- b. If the auditor is not able to obtain sufficient appropriate evidence to support the opinion, the auditor should 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*.

Under the proposal, in cases where the auditor did not obtain sufficient appropriate audit evidence to support the opinion, the auditor would have been required to either obtain additional evidence such that the opinion is adequately supported or take action to prevent future reliance on the report. One firm suggested that further guidance regarding these requirements would assist a firm in distinguishing between the engagement deficiencies that are subject to this provision rather than paragraph .04 (discussed below), or in the alternative, explicit alignment to the PCAOB's definition of a Part I.A or Part I.B deficiency.³⁶⁶ We are reluctant to incorporate terminology into our standards that does not have a fixed meaning under our rules and is subject to change.³⁶⁷ We also do not want to suggest that the requirements apply only to deficiencies identified by the PCAOB. However, in order to address this concern, we have revised paragraphs .03a and .03b to make it explicit that the auditor's actions in paragraph .03b relate specifically to instances where the auditor is not able to obtain sufficient appropriate audit evidence to support the auditor's opinion.

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 is not able to obtain sufficient appropriate evidence to support the opinion, the auditor is required to take appropriate action to prevent future reliance on the audit report. We are also amending AS 2201 as part of this rulemaking to include a reference to AS 2901 as a reminder of auditor responsibilities under that section with respect to audits of internal control over financial reporting.³⁶⁸

³⁶⁶ Subsequent to the date of the comment letter, the PCAOB created an additional category, Part I.C deficiencies. Definitions of Part I.A, Part I.B, and Part I.C deficiencies are available on the PCAOB website at <https://pcaobus.org/oversight/inspections/inspection-procedures>.

³⁶⁷ As an example of how the Board's inspection reporting framework can change over time, in May 2023, the Board introduced several transparency enhancements to its inspection reports, including a new section of the inspection report focused on independence violations (Part I.C).

³⁶⁸ See Appendix 5, Other Amendments.

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: As appropriate, actions a firm may take include preventive or corrective actions, or a combination, such as actions: (1) to address engagement deficiencies on completed engagements; and (2) to deter future engagement deficiencies.

Under the proposed standard, for all other deficiencies on audit engagements, the auditor would have been required to 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. The proposal described the following 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.
- 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.

One commenter suggested including language in the lead-in to the note to paragraph .04 to further clarify that the actions a firm may take to remediate an engagement deficiency could be either corrective or preventive, or could be a combination of the two. We agree and the note in the final standard reflects this clarification.

Additionally, the term "remedial" has been removed from the final standard in the lead-in to the note to paragraph .04 in order to encompass all actions required under applicable professional and legal requirements, some of which (e.g., notification to the board of directors or regulatory agencies) may not be remedial in nature.

c. Documentation

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.

The proposed documentation requirement did not draw comment and is adopted as proposed.

When the auditor's response to engagement deficiencies involves adding additional information to the auditor's working papers, the requirements of AS 1215.16 will apply.

Under AS 2901, the auditor should 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 amendments

We proposed to add 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.

One commenter, who recommended changes to proposed AS 2901 (including that remediation should be required only when the auditor's opinion may not be supported), suggested that the same changes be incorporated into AT No. 1 and AT No. 2. For the reasons discussed in Section IV.K.1.g.v above in the context of AS 2901, we do not believe such a limitation is appropriate. However, we have made a conforming change, similar to a change made to AS 2901, to the note to clarify that the auditor must treat reports as being relied upon when the examination report (in the case of AT No. 1) or review report (in the case of AT No. 2) is included (either directly or through incorporation by reference) in an SEC filing on an SEC form that requires inclusion of such an examination report or review report. We also made revisions to the proposed requirements in AT No. 1 and AT No. 2 by removing the word "remedial" from the lead-in language to the notes in each of the respective standards in order

to encompass all actions required under applicable professional and legal requirements, some of which (e.g., notification to the board of directors or regulatory agencies) may not be remedial in nature. With these modifications, we are adopting the proposed amendments to AT No. 1 and AT No. 2.

The text of the amendments to AT No. 1 and AT No. 2 appears in Appendix 5.

We are also amending AS 2201 as part of this rulemaking to include a reference to AS 2901 as a reminder of auditor responsibilities under that section with respect to audits of internal control over financial reporting.³⁶⁹

We did not propose to amend our interim attestation standards to include provisions similar to AS 2901. One commenter encouraged the Board to consider creating a separate attestation standard like AS 2901 to minimize repetition within each attestation standard, especially if the Board plans to adopt new standards beyond AT No. 1 and AT No. 2 in the future. At this time, we are not amending our interim attestation standards to include provisions similar to AS 2901, though we may consider doing so in the future.

B. Rescission of ET Section 102; adoption of EI 1000; related amendments

1. Rescission of ET Section 102 and adoption of EI 1000, *Integrity and Objectivity*

We are rescinding an interim ethics and independence standard, ET 102, *Integrity and Objectivity*, and replacing it with a new standard, EI 1000, *Integrity and Objectivity*. EI 1000 is based on existing ET 102, including its related interpretations codified as ET 102.02, .03, and .05, but reflects revisions that align our ethics requirements with the scope, approach, and terminology of QC 1000. To take one example, the new EI 1000 applies to registered public accounting firms and their associated persons rather than current AICPA “members” as referenced in ET 102.

.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 company employees and boards of directors, other firm personnel, and regulators), a registered public accounting firm (“firm”) and its associated persons must maintain integrity and objectivity.

.02 Integrity includes:

³⁶⁹ See Appendix 5, Other Amendments.

- 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) when having the authority to do so, failing to correct a document that is materially false or misleading when made (including when filed with or submitted to a regulatory authority), or when otherwise subject to a duty to correct the document.
- 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.³⁷⁰

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

³⁷⁰ *United States v. Arthur Young*, 465 U.S. 805, 817-818 (1984).

subject to cognitive or other biases in performing the audit.³⁷¹ 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.

We proposed creating 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. The proposal incorporated descriptions of integrity and objectivity that were substantially based on existing requirements in QC 20.10.³⁷²

In addition to substantially recodifying existing requirements, we also proposed to clarify the scope of the rule and more closely align it with the scope, approach, and terminology of QC 1000.

With two clarifications discussed below, we are adopting EI 1000 as proposed and rescinding ET 102.

a. General

As proposed, we have modernized the standard and aligned it with our other standards and rules by renumbering it in accordance with our reorganized standards framework, incorporating PCAOB terminology, and eliminating outdated provisions.

The final rule clarifies that the requirements of EI 1000 apply in connection with all responsibilities under "applicable professional and legal requirements" (as defined in 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' engagements, training, independence monitoring, or other activities that are part of or subject to the firm's QC system. In addition, EI 1000 applies to

³⁷¹ See, e.g., *Auditing Accounting Estimates, Including Fair Value Measurements and Amendments to PCAOB Auditing Standards*, PCAOB Rel. No. 2018-005 (Dec. 20, 2018), at 30-35 (discussing auditor incentives and potential cognitive biases).

³⁷² 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."

registered firms and their associated persons, rather than to “members” as ET 102 currently provides.

The final rule also corrects a reference in EI 1000.02.b(2) from “materially false and misleading” to “materially false or misleading.”

One commenter supported the replacement of ET 102 with EI 1000, but recommended labeling it “OI” for Objectivity and Integrity. As described in the proposal, we are creating a designation not only for our standard on objectivity and integrity, but for future standards as well. We intend to use “EI” for all ethics and independence standards, just as we use “AS” to designate auditing standards.

While one commenter confirmed that the terms used in EI 1000 are generally clear, another commenter recommended clarifying the expectations for the terms “being honest and candid” in EI 1000.02 and “being intellectually honest” in EI 1000.03. This language is drawn from existing QC 20.10, has a clear plain English meaning, and we believe should be well understood.

b. Integrity

EI 1000.02 notes that, as part of maintaining integrity, a firm and its associated persons must be “honest and candid.” This requirement is drawn from existing QC 20.10. We have omitted 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 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, EI 1000.02 does 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.³⁷³

One commenter suggested that, rather than removing the reference to confidentiality, we should instead refer to IESBA Code Section 260 related to noncompliance with laws or

³⁷³ 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.” AICPA, *Uniform Accountancy Act* (January 2018). available at <https://us.aicpa.org/content/dam/aicpa/advocacy/state/downloadabledocuments/uaa-eighth-edition-january-2018.pdf>.

regulations. In general, we do not incorporate by reference the concepts and terminology used by other standard setters. In relation to noncompliance with laws and regulations in particular, we have proposed our own new standard.³⁷⁴ If a new PCAOB standard in that area is ultimately adopted by the Board and approved by the SEC and makes it appropriate for us to amend EI 1000, we would of course intend for EI 1000 to align with our new standard rather than the IESBA code.

The proposal clarified 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.

One commenter suggested that the concept of failing to correct a document that is materially false and misleading when having the authority to do so should be limited to circumstances in which the document was materially false and misleading “when made.” We agree that the duty to correct is not unbounded, and generally applies at the time that a document is made (including when filed with or submitted to a regulatory authority). We note, however, that while EI 1000 does not independently impose a duty to correct a document that was not materially false or misleading when made, such a duty may arise under other statutes, laws, or regulations, and we believe that in such a circumstance, the failure to discharge that duty should also constitute a violation of EI 1000. We have added language to EI 1000.02b to clarify the circumstances under which failure to correct a document would constitute a knowing or reckless misrepresentation of facts.

We proposed to broaden 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. One commenter suggested that, as part of the provision on subordination of judgment, we should address the risk of supervisors exercising undue influence over subordinates in the same manner as under the AICPA Code of Professional Conduct.³⁷⁵ The relevant interpretive provision of the AICPA Code, 1.130.020, *Subordination of Judgment*, identifies undue influence by a supervisor as a potential threat to compliance with the AICPA’s Integrity and Objectivity Rule³⁷⁶ and provides safeguards to be applied when the threat is not at an acceptable level. The safeguards to be applied are essentially the same as the

³⁷⁴ See *Proposing Release: Amendments to PCAOB Auditing Standards related to a Company’s Noncompliance with Laws and Regulations And Other Related Amendments*, PCAOB Rel. No. 2023-003 (Jun. 6, 2023).

³⁷⁵ AICPA Code of Professional Conduct 1.130.020, *Subordination of Judgment*.

³⁷⁶ *Id.* at 1.100.001.

process required under EI 1000.02c, including research and consultation to determine whether the supervisor's position is supportable, consultation with higher levels of management, and, if appropriate action is not taken, consideration of potential duties to notify third parties and consideration of the appropriateness of continuing a relationship with the firm. In addition to the provision in EI 1000, QC 1000 also addresses the risk of undue influence through a quality objective in the engagement performance component related to the appropriate resolution of differences in professional judgment,³⁷⁷ as well as general provisions that would apply to undue influence by a supervisor, including in the governance and leadership component,³⁷⁸ the ethics and independence component,³⁷⁹ and the resources component.³⁸⁰ We believe these provisions address the concerns raised by this commenter and have adopted the subordination of judgment provision of EI 1000 as proposed.

c. Objectivity

One commenter suggested that we could clarify the standard by including references to the AICPA or IESBA concepts of conflict of interest. As noted above, it is not generally our policy to incorporate by reference the concepts and terminology used by other standard setters. We also believe that a cross reference is not appropriate because EI 1000 addresses essentially the same conduct as the AICPA and IESBA provisions.

d. Rescission of Certain AICPA Interpretations

Additionally, we are rescinding 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. These are generally not relevant to engagements performed under PCAOB standards. In addition, 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*).

2. Amendments to ET Section 191

In connection with EI 1000, we also proposed amending ET 191 by making a conforming amendment to paragraph .062 and rescinding paragraphs .130, .131, .170, .171, .186, .187, .198, .199, .202, and .203. The only commenter on this topic supported these amendments. We

³⁷⁷ QC 1000.42.c.

³⁷⁸ QC 1000.25.

³⁷⁹ QC 1000.33b, c., and f.

³⁸⁰ QC 1000.46a.

are adopting the amendments as proposed. The interpretations we have 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 amending the portions of ET 191 that pertain to ET 101, which is not being substantively amended in this rulemaking.

3. Amendments to Rule 3500T, *Interim Ethics and Independence Standards*, and ET Section 101, *Independence*

We proposed amending 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 proposed eliminating references to ET 102, *Integrity and Objectivity*, and substituting a reference to EI 1000, *Integrity and Objectivity*. These proposed amendments did not receive any comment and are being adopted as proposed.

Lastly, we are amending paragraphs .04, .13, and .16 of ET 101, *Independence*, to conform the references to ET 102, which will be rescinded, to EI 1000.

See Appendix 4 for the rule text.

C. Other Amendments

In connection with the adoption of QC 1000, the Board is also adopting amendments to other professional standards, PCAOB rules, and PCAOB forms. As discussed in more detail below, these amendments:

- Align terminology, concepts, and cross-references with QC 1000;
- Rescind standards that are unnecessary in light of the adoption of QC 1000;
- Recodify certain provisions of requirements that are rescinded into other PCAOB standards and rules; and
- Make other technical and clarifying amendments.

The one commenter that addressed this topic generally supported the amendments and also recommended an amendment to PCAOB Rule 1001(p)(vi) to use the term “quality control standards” instead of “quality control policies and procedures.” The language used in PCAOB Rule 1001(p)(vi) is drawn from Section 110(5) of Sarbanes-Oxley and we believe our rule should continue to align with that statutory provision.

These amendments are discussed further below and the text of the amendments appears in Appendix 5.

1. Rescission of Rule 3400T, *Interim Quality Control Standards*; Adoption of Rule 3400, *Quality Control Standards*

These rule changes did not receive any comment and are being adopted as proposed.

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 rescinding Rule 3400T, including all current QC standards identified in the rule, which the Board adopted on an interim, transitional basis.³⁸¹ The complete list of QC standards is included in Appendix 5. We are adopting in its place a new rule, Rule 3400, to codify the auditor's responsibilities for complying with the Board's quality control standards.

2. Rescission of AS 1110, *Relationship of Auditing Standards to Quality Control Standards*

We received no comment on the proposed rescission of AS 1110 and are rescinding it, as proposed.

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 QC 1000. In addition, the first two paragraphs of AS 1110 merely repeat the requirements to comply with the auditing and QC standards that are addressed by other PCAOB standards and rules. Accordingly, we are rescinding AS 1110.

3. Adoption of AS 1310, *Notification of Termination of the Auditor-Issuer Relationship*

We are adopting a new standard, AS 1310, which recodifies existing requirements of SECPS § 1000.08(m), *Notification of the Commission of Resignations and Dismissals from Audit*

³⁸¹ 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(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). The note to 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."

Engagements for Commission Registrants, and applies those requirements to all firms and all issuer engagements. As noted above, we are rescinding 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 adopting a new standard that requires the auditor 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.

The only commenter to address this proposed standard agreed that it could provide valuable and timely information to investors to alert them when audit committees have failed to fulfill their reporting responsibilities. We note, however, that notifications provided under the current SECPS requirement might not be made publicly available. Nevertheless, we believe that notices provided to the SEC under the standard we are adopting today could provide valuable information to the SEC. Therefore, we are adopting the standard substantially as proposed, with a revision to conform to the precise language on Form 8-K. This requirement applies 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.

4. Amendments to AT Section 101, *Attest Engagements*

These amendments did not receive any comment and are being adopted as proposed.

The amendments to AT Section 101 align with the rescission of AS 1110 discussed above, by deleting the paragraphs that address the relationship of attestation standards to QC standards. Additionally, the deletion of footnote 23 removes language related to monitoring compliance with quality control policies and procedures, which is unnecessary in light of the adoption of QC 1000.

5. Amendments to Form 1, *Application for Registration*

We proposed 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 confirm whether they have designed a QC system in accordance with PCAOB standards. The only commenter to address this amendment agreed that the amendments would be appropriate. We are adopting these amendments as proposed.

6. Amendments to Form 2, *Annual Report Form*

We proposed 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. The only commenter to address this

amendment agreed that the amendments would be appropriate. We are adopting these amendments as proposed.

7. Technical and conforming amendments

These amendments did not receive any comment and are being adopted as proposed.

We are implementing a number of technical and conforming amendments to align terminology and concepts in existing standards and one PCAOB form with QC 1000.

We are also implementing 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.³⁸² 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 are revising 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 clarifies 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.

VI. ECONOMIC ANALYSIS

Economic analysis is an important aspect of the rulemaking process. This economic analysis describes the baseline for evaluating the economic impacts of the rulemaking, the need for rulemaking, its expected economic impacts (including benefits, costs, and potential unintended consequences), and reasonable alternatives considered. Due to data limitations, much of the economic analysis is qualitative in nature; however, where reasonable and feasible, the analysis incorporates quantitative information, including information from PCAOB inspections of registered firms.

³⁸² 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 Rel. No. 2015-008 (Dec. 15, 2015), at 26.

The Board has sought information relevant to the economic analysis over the course of this rulemaking.³⁸³ To the extent that commenters expressed views related to the economic analysis, many commenters generally agreed with the need for QC 1000, but some commenters raised concerns with certain impacts of the proposed standard. Several commenters expressed concerns about costs associated with certain key requirements, such as documentation. Some commenters suggested that the economic analysis should more explicitly consider costs that could disproportionately impact smaller and mid-size firms. Some commenters asserted potential unintended consequences with the proposed standard, including demand on staff resources and potential competitive effects, while other commenters suggested alternatives to help manage costs associated with certain proposed requirements, such as the 100-issuer threshold and evaluation and reporting dates. Some commenters offered a quantitative perspective regarding impacts. Several commenters referenced additional academic research for our consideration. The Board has considered all the comments received, including the quantitative perspectives and academic research the comments referenced, and has developed the following economic analysis that evaluates the expected benefits and costs of the final requirements, discusses potential unintended consequences, and facilitates comparison to alternative actions considered.

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 economic impacts of the 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 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 expected benefits of the requirements (e.g., improved compliance with professional standards).³⁸⁴
- Section VI.A.2 presents information on resources that U.S. global network firms (“GNFs”) invest in their QC systems. As the requirements are expected to result in changes to some firms’ QC systems, this information informs the baseline for considering the expected costs of the requirements.

³⁸³ See PCAOB Rel. No. 2022-006; PCAOB Rel. No. 2019-003.

³⁸⁴ See Section VI.C.1.b below for further discussion.

- Section VI.A.3 describes changes firms have made to their QC systems to remediate QC deficiencies identified by inspections staff and presents QC deficiencies related to firms' management of their audit practices. This discussion provides information on the evolution of QC systems and informs the evaluation of the need for and the economic impacts of the 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 requirements.

In describing the baseline,³⁸⁵ 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 report³⁸⁶ may relate to: (1) a firm's management of its audit practice or (2) a firm's performance of audit procedures.³⁸⁷ QC deficiencies of the first type refer to the operation of QC policies

³⁸⁵ 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 and firms that play a substantial role in the preparation or furnishing of such audit reports. 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 June 30, 2023, approximately 60% 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.

³⁸⁶ Part II of a firm's inspection report includes any criticisms of, and potential defects in, the firm's QC system, that were communicated to the firm as part of our inspection. As required under Sarbanes-Oxley, 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>.

³⁸⁷ See PCAOB Rel. No. 2012-003, at 8-9.

- 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 engagement 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.³⁸⁸
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 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 significant defects or potential defects in a firm's QC system that should appear in Part II of the firm's inspection report.³⁸⁹
 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

³⁸⁸ See PCAOB Rel. No. 2012-003, at 8.

³⁸⁹ Additional information on PCAOB inspection procedures is available on the PCAOB website at <https://pcaobus.org/oversight/inspections/inspection-procedures>.

- summarizes the results of the PCAOB's inspections of broker-dealer engagements performed during the previous year.³⁹⁰
4. Our analysis of QC and issuer audit deficiencies below is presented over a twelve-year period for three separate categories of firms: (1) U.S. GNFs, (2) other firms having more than five inspected issuer engagements, and (3) other firms having five or fewer inspected issuer engagements.³⁹¹ Categorizing inspections information among firms of different sizes helps account for the significantly skewed variation in audit firm size present in the audit market.³⁹² We use the 2011 through 2022 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 2022 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 a twelve-year period. We use the 2011 through 2022 period because 2011 was the first year of the interim inspection program and 2022 is the most recent year that data are available as of the date of our analysis. Information on deficiencies associated with attestation examinations or reviews is not available prior to 2015 because 2015 was the first full year during which the PCAOB was able to review attestation engagements of brokers and dealers.

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

³⁹⁰ See *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers*, PCAOB Rel. No. 2023-005 (August 10, 2023). 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>.

³⁹¹ Time trends can help to identify associative relationships and may suggest how the audit market could evolve absent the 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 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.

³⁹² 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 PCAOB Rel. No. 104-2006-077, at 9-10.

considering the key expected benefit of the requirements: improved compliance with professional standards. Specifically, we present information on Part I.A deficiencies, QC deficiencies related to audit performance, and broker-dealer engagement deficiencies, from the audits or engagements PCAOB inspected. Overall, the analyses 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 more room for improvement on average based on the period examined.

a. Part I.A deficiencies

Figure 1 presents for categories of PCAOB-inspected audits 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 should not be equated with the rate of audit deficiencies across the whole issuer population. 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 Part I.A deficiency rates presented in Figure 1 are indicative of underlying issuer audit deficiencies. However, we note two caveats that may impact the interpretation of Figure 1. First, because the audits with deficiencies are not drawn from a random sample, the deficiencies 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 was 37% in 2011 and 30% in 2022. For other firms, the percentage has remained in the 31% to 53% range.

Figure 1. Percentage of Inspected Issuer Audits Having at Least One Part I.A Deficiency (2011-2022)

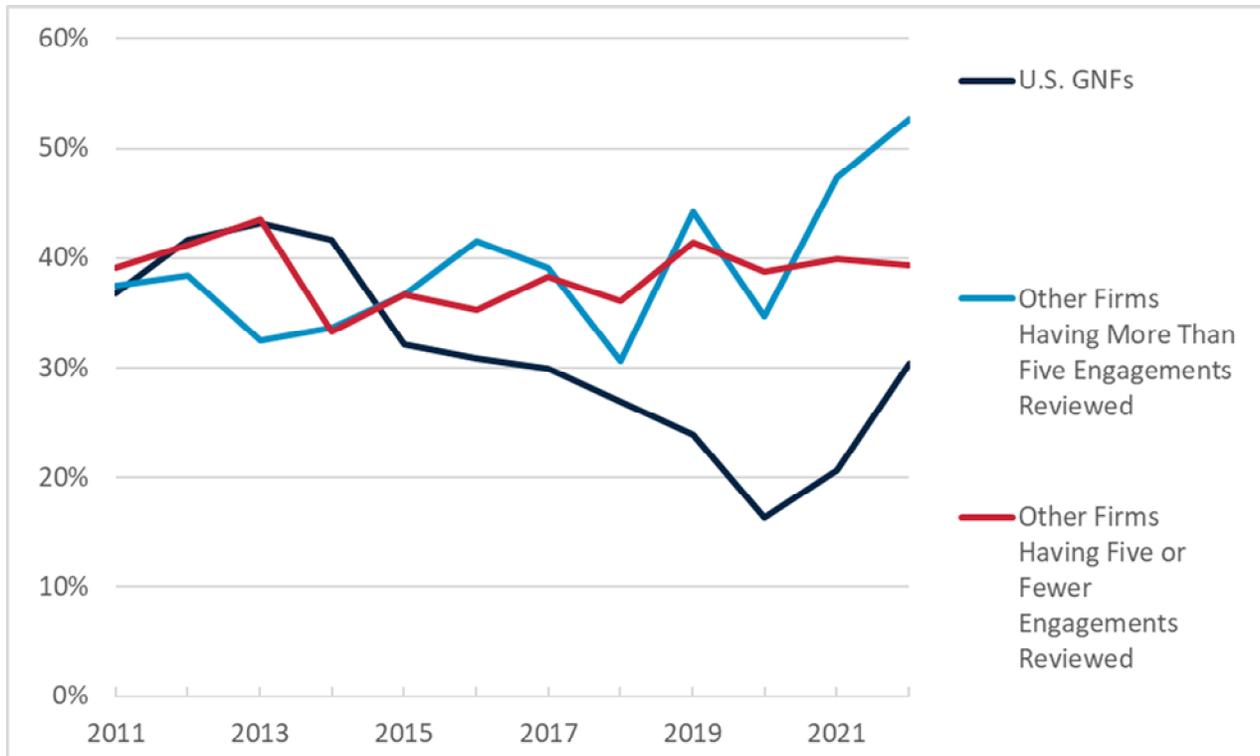
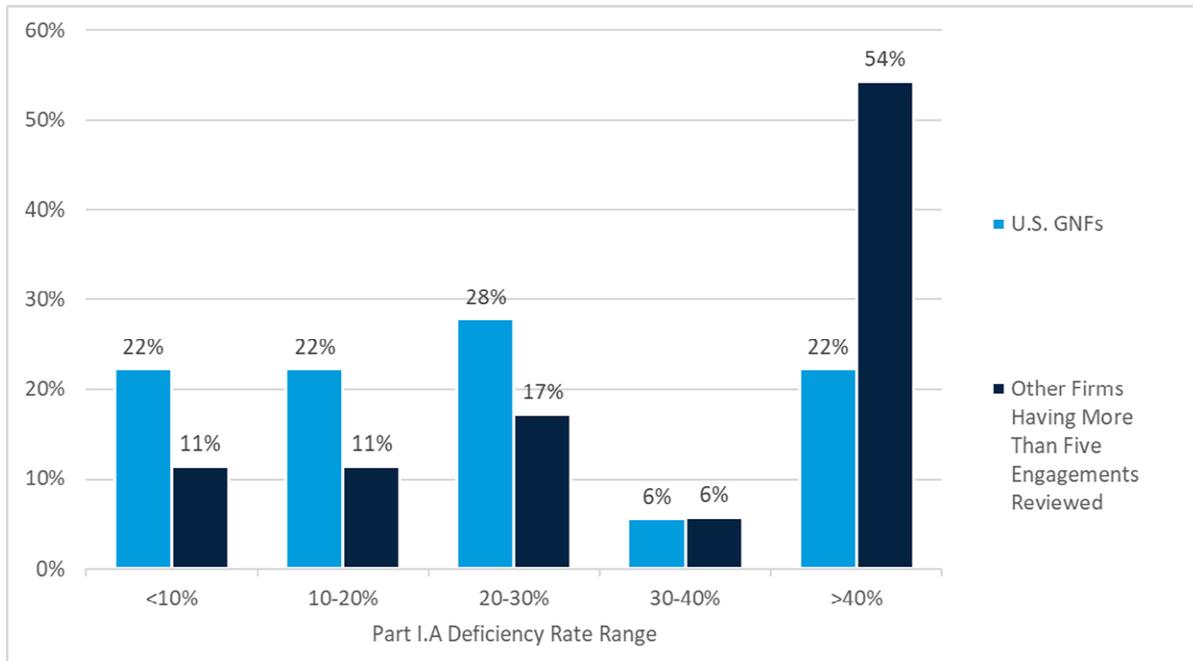


Figure 2 provides additional insight on how the percentage of inspected issuer audits having at least one Part I.A deficiency varies by firm. Each bar indicates the percentage of 2020, 2021, and 2022 firm inspections with a Part I.A deficiency rate within a given range. For example, Figure 2 indicates that 22% of all 2020, 2021, and 2022 U.S. GNP inspections and 11% of all 2020, 2021, and 2022 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 (2020-2022)



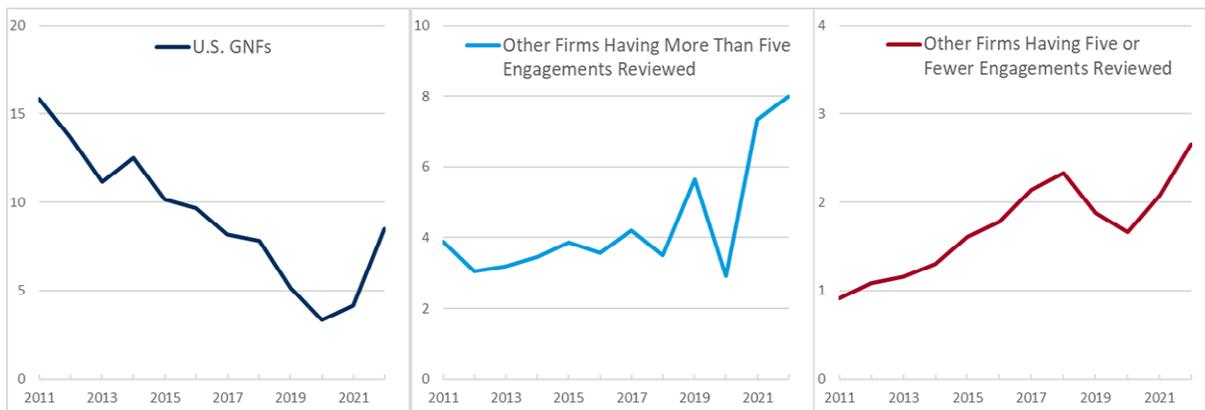
Note: During the 2020, 2021, and 2022 inspection years, there were in total 18 inspections of U.S. GNFS and 35 inspections of other firms having more than five engagements reviewed.

b. QC deficiencies related to audit performance

Figure 3 presents 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 in Part II of PCAOB inspection reports. Staff assigned a zero to firm inspections that 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 is not readily comparable across each of the three categories of firms because of differences in inspection approach, the averages have ranged between 3.3 and 15.8 for U.S. GNFS, between 2.9 and 8.0 for other firms having more than five engagements reviewed, and between 0.9 and 2.7 for other firms having five or fewer engagements reviewed. We note two caveats that may impact the interpretation of Figure 3. First, 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 U.S. GNFs. Second, the variability in the deficiency rate in the second panel may be due in part to year-over-year changes in the set of firms having more than five engagements reviewed, which may include triennial firms.³⁹³

Figure 3. Average Number of QC Deficiencies Related to Audit Performance Per Inspected Firm (2011-2022)

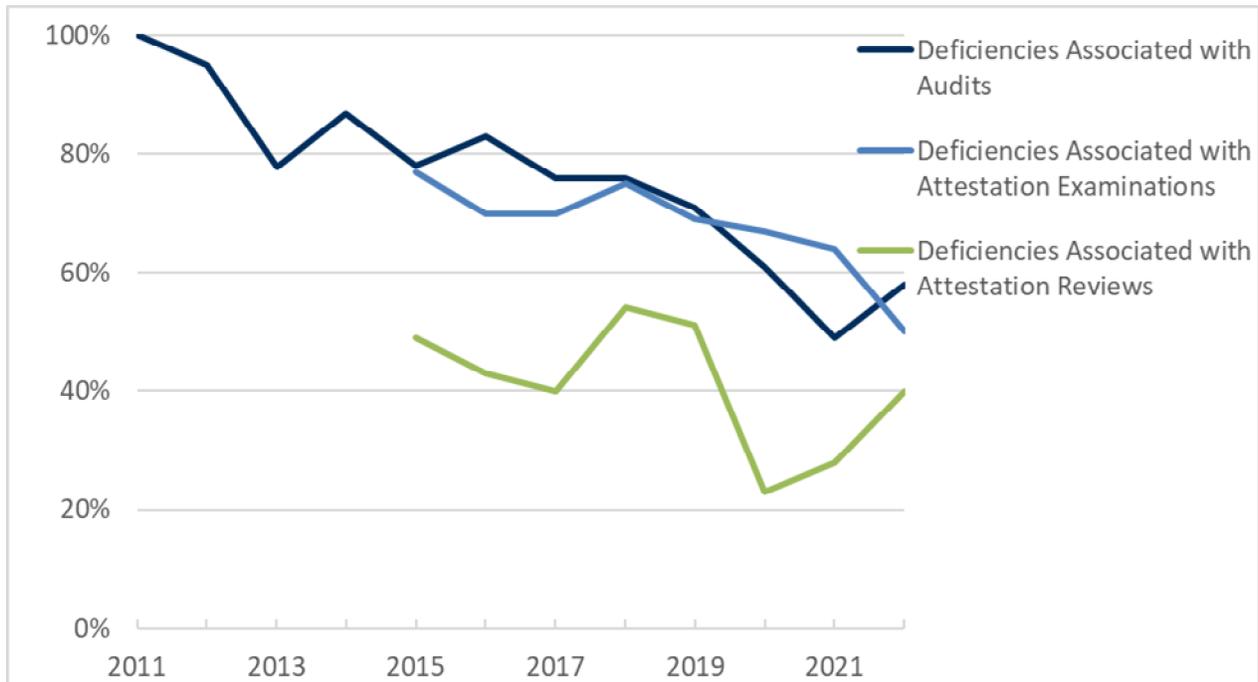


c. Broker-dealer engagement deficiencies

Figure 4 presents the percentage of broker-dealer audits with deficiencies and the percentage of attestation engagements and reviews with deficiencies, among the selected sample of PCAOB engagements. The percentages are reproduced from the PCAOB’s annual reports on the interim inspection program related to the audits of broker-dealers. The percentages are equal to the number of inspected engagements for which there were deficiencies divided by the number of inspected engagements. The percentages of audits and attestation examinations with deficiencies have remained greater than 45%. The percentage of attestation reviews with deficiencies has remained in the 23% to 54% range.

³⁹³ 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.

Figure 4. Percentages of Broker-Dealer Engagements with Deficiencies (2011-2022)



2. Resources associated with QC systems

Firms implement their QC systems through a set of policies and procedures. These policies and procedures vary 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 expected costs of the 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 indicates the resources that U.S. GNFs are already devoting 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.³⁹⁴ In addition, the survey requested qualitative and quantitative

³⁹⁴ See paragraphs 23-33 and 35-47 of ISQM 1.

information related to network requirements or network services, evaluation of the QC system, and documentation.³⁹⁵ 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 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. These 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 asked the U.S. GNFs 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 became effective.³⁹⁶ Staff asked the firms to include in their estimates only those

³⁹⁵ See paragraphs 48-60 of ISQM 1.

³⁹⁶ More specifically, staff asked U.S. GNFs 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 the individual's 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.

resources directly related to the design, implementation, and operation of 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 audits performed under other 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 operating 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.³⁹⁷ 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 a mean of 647.9 total FTEs to designing, implementing, and operating their QC policies and procedures. QC policies and procedures related to: (1) independence and ethics utilize a mean of 189.9 total FTEs and (2) human, intellectual, and technological resources utilize a mean of 252.6 total FTEs. Non-partner

³⁹⁷ 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 are insufficient to account for potential covariances between these components.

FTEs are roughly 3.5 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 that the average variability across firms is 499.9 total FTEs. The average variability for the independence and ethics component is 173.9 total FTEs and for the resources component is 295.2 total FTEs.

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 ³⁹⁸	4.1	0.6	11.6	2.5	15.6	2.8
Total	143.6	85.3	504.3	428.9	647.9	499.9

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 became effective. The qualitative information provided by the firms indicates that: (1) additional resources likely were required; (2) some of the U.S. GNFs had assigned teams to manage ISQM 1 implementation; and (3) the risk assessment component and the evaluation of the system of quality management component were expected to require the most additional resources.

We also received information regarding non-GNFs through the proposal comment process that indicates that non-GNFs have devoted resources to the design, implementation, and operation of QC policies and procedures related to ISQM 1 and/or SQMS 1 requirements. One commenter noted that national firms with fewer than 500 issuers have significantly fewer resources associated with QC policies and procedures.³⁹⁹ One commenter noted that firms have invested significant time and resources to comply with the existing quality management standards from other standard setters, and another commenter noted that, at least with respect to QC roles and responsibilities, smaller firms have already designed their processes to accord with ISQM 1 and SQMS 1. One firm explained that its implementation efforts of ISQM 1 required a great deal of evaluation of risks and related responses, and another firm explained

³⁹⁸ The "Other" category includes network requirements or network services, evaluation of the system of quality management, and documentation.

³⁹⁹ The commenter asserted that the mean total FTEs reported in Table 1 for GNFs represent approximately 10% of partners and employees for firms of similar size and composition to the commenter. We note, however, that the commenter also reported having approximately 90% fewer partners and employees than some U.S. GNFs and approximately 99% fewer than other U.S. GNFs, so the resources reported in Table 1 would likely be scaled down accordingly for the commenter and similar sized firms.

that its implementation effort was a significant undertaking that involved a number of people across the firm. Another commenter suggested that non-U.S. firms may be incorporating quality management frameworks adopted by their local regulator, such as CPAB's Quality Management System framework. Several commenters representing non-GNF perspectives focused more generally on the provisions of QC 1000 that diverge from ISQM 1 and SQMS 1, which we understand as implying that these firms had expended resources to construct and operate quality control systems in compliance with those standards. However, at least one commenter noted that for small firms that do not need to comply with ISQM 1, efforts may be ongoing to implement SQMS 1, indicating that some of these firms may be focused on resources for design and may not yet be spending resources to operate QC policies in line with SQMS 1.

One commenter noted research that appears to be too tangential or unrelated to actual resources employed by firms to be useful for advancing our understanding of resources associated with the design, implementation, and operations of their QC systems. The commenter noted that most academic studies related to resources employed by NAFs or foreign affiliates of GNFs in the design, implementation, and operations of their QC systems focus on either: (1) the contributions of internal quality reviews to audit firm quality⁴⁰⁰ or (2) the association of audit firm network arrangements, as proxies for resources, with audit quality.⁴⁰¹ For example, one study suggests that when firms have formal connections via networks or large alliance arrangements, audits within those arrangements have similar levels of quality,⁴⁰² which the commenter noted may imply that formal connections are a vehicle to share and enforce QC practices.

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

⁴⁰⁰ See, e.g., Richard W. Houston and Chad M. Stefaniak, *Audit Partner Perceptions of Post-Audit Review Mechanisms: An Examination of Internal Quality Reviews and PCAOB Inspections*, 27 *Accounting Horizons* 23 (2013); Denise Hanes Downey and Kimberly D. Westermann, *Challenging Global Group Audits: The Perspective of US Group Audit Leads*, 38 *Contemporary Accounting Research* 1395 (2021); Olof Bik and Reggy Hooghiemstra, *Cultural Differences in Auditors' Compliance with Audit Firm Policy on Fraud Risk Assessment Procedures*, 37 *Auditing: A Journal of Practice & Theory* 25 (2018).

⁴⁰¹ See, e.g., Renee Flasher and Kristy Schenck, *Exploring PCAOB Inspection Results for Audit Firms Headquartered Outside of the US*, 37 *Journal of International Accounting, Auditing and Taxation* 1 (2019); Philip Keejae Hong, David S. Kerr, and Casper E. Wiggins, *PCAOB International Inspections: Updates and Extensions*, 26 *International Journal of Auditing* 279 (2022); Matthew S. Ege, Young Hoon Kim, and Dechun Wang, *Do Global Audit Firm Networks Apply Consistent Audit Methodologies across Jurisdictions? Evidence from Financial Reporting Comparability*, 95 *The Accounting Review* 151 (2020).

⁴⁰² See Flasher and Schenck, *Exploring PCAOB Inspection Results* 1.

remediate QC deficiencies identified in inspection reports. Second, it presents analyses of 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.

Many firms have implemented a number of changes to their QC systems to remediate their QC deficiencies.⁴⁰³ 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:⁴⁰⁴

- 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 ICFR 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;

⁴⁰³ Additional information about the PCAOB remediation process is available on the PCAOB website at https://pcaobus.org/oversight/inspections/remediation/remediation_process.

⁴⁰⁴ 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 Rel. 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 QC 1000.

One commenter, an academic, referred to a recent unpublished study examining how firms change and manage their QC systems, which involved surveying QC leaders from eight U.S. accounting firms. The commenter reported that the three most common changes currently underway in the firms relate to: (1) engagement monitoring and use of data analytics; (2) organizational structure (e.g., a dedicated ISQM team, independent advisors); and (3) a more proactive approach to identifying QC issues.⁴⁰⁵

Figure 5 presents 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 in Part II of PCAOB inspection reports. Staff assigned a zero to firm inspections that 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 are not readily comparable across each of the three categories of firms, the averages have ranged between 0.8 and 10.2 for U.S. GNFs, between 0.3 and 1.5 for other firms having more than five engagements reviewed, and between 0.3 and 0.6 for other firms having five or fewer engagements reviewed.

⁴⁰⁵ The commenter also reported that the three most commonly described ideal changes relate to: (1) engagement monitoring and use of data analytics; (2) human talent-related initiatives such as changes to hiring and promotion practices; and (3) client risk assessment processes. Ideal changes are described as changes the QC leaders would make if the firms did not face resource constraints.

Figure 5. Average Number of QC Deficiencies Related to Firms' Management of Their Audit Practice per Inspected Firm (2011-2022)



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.”⁴⁰⁶

Some commenters provided additional specific examples of quality-threatening behaviors. For example, one commenter reported that some academic research finds auditors may not always be objective when deciding on the acceptability of management’s accounting choices or when recommending audit adjustments that would reduce reported income or assets.⁴⁰⁷ Citing a settlement between a U.S. GNF and the Federal Deposit Insurance

⁴⁰⁶ Monika Causholli and W. Robert Knechel, *An Examination of the Credence Attributes of an Audit*, 26 *Accounting Horizons* 631, 647 (2012).

⁴⁰⁷ See, e.g., Kathryn Kadous, Jane S. Kennedy, and Mark E. Peecher, *The Effect of Quality Assessment and Directional Goal Commitment on Auditors’ Acceptance of Client-Preferred Accounting Methods*, 78 *Accounting Review* 759 (2003); Christopher Koch and Steven E. Salterio, *The Effects of Auditor Affinity for Client and Perceived Client Pressure on Auditor Proposed Adjustments*, 92 *Accounting Review* 117 (2017); Lori Shefchik Bhaskar, Patrick E. Hopkins, and Joseph H. Schroeder, *An Investigation of Auditors’ Judgments When Companies Release Earnings before Audit Completion*, 57 *Journal of Accounting Research* 355 (2019).

Corporation, another commenter asserted that one firm's QC system failed when one of the firm's engagement teams inappropriately assigned a responsibility to an intern.

Research suggests that quality-threatening behaviors imply a failure of QC systems to provide reasonable assurance of compliance.⁴⁰⁸ Moreover, some research suggests that, while not solely responsible, certain features of firms' management of their audit practice may encourage quality-threatening behaviors.⁴⁰⁹ For example, experimental research suggests that certain cognitive biases in auditor evaluation and reward systems may inadvertently deter appropriate professional skepticism⁴¹⁰ and other studies suggest that partner reward systems at some firms may weight revenue generation more heavily than professional competencies.⁴¹¹ Some research finds that reward systems oriented toward revenue generation are associated with lower proxies for audit quality.⁴¹² Synthesizing several recent academic studies, one commenter reported that an excessive focus on commercialism, rather than professionalism, continues to be a dominant focus within firms' cultures and may negatively impact audit quality.⁴¹³ The commenter also reported that academic research indicates quality-threatening

⁴⁰⁸ 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*, 27 *Auditing: A Journal of Practice & Theory* 187 (2008).

⁴⁰⁹ 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*, 19 *Journal of Applied Business Research* 95 (2003).

⁴¹⁰ See, e.g., Joseph F. Brazel, Scott B. Jackson, Tammie J. Schaefer, and Bryan W. Stewart, *The Outcome Effect and Professional Skepticism*, 91 *The Accounting Review* 1577 (2016).

⁴¹¹ See, e.g., Marie-Laure Vandenhoute, Kris Hardies, and Diane Breesch, *Professional and Commercial Incentives in Audit Firms: Evidence on Partner Compensation*, 29 *European Accounting Review* 521 (2020).

⁴¹² See, e.g., Jürgen Ernstberger, Christopher Koch, Eva Maria Schreiber, and Greg Trompeter, *Are Audit Firms' Compensation Policies Associated With Audit Quality?* 37 *Contemporary Accounting Research* 218 (2020); Thomas Riise Johansen and Jeppe Christoffersen, *Performance Evaluations in Audit Firms: Evaluation Foci and Dysfunctional Behavior*, 21 *International Journal of Auditing* 24 (2017).

⁴¹³ See, e.g., Christina Thomas Alberti, Jean C. Bedard, Olof Bik, and Ann Vanstraelen, *Audit Firm Culture: Recent Developments and Trends in the Literature*, 31 *European Accounting Review* 59 (2022); Chris Carter and Crawford Spence, *Being a Successful Professional: An Exploration of Who Makes Partner in the Big 4*, 31 *Contemporary Accounting Research* 949 (2014); Ken H. Guo, *The Institutionalization of Commercialism in the Accounting Profession: An Identity-Experimentation Perspective*, 35 *Auditing: A Journal of Practice and Theory* 99 (2016); Claire-France Picard, Sylvain Durocher, Yves Gendron, *The Colonization of Public Accounting Firms by Marketing Expertise: Processes and Consequences*, 37 *Auditing: A Journal of Practice & Theory* 191 (2018); Jonathan S. Pyzoha, Mark H. Taylor, and Yi-Jing Wu, *Can Auditors Pursue Firm-Level Goals Nonconsciously on Audits of Complex Estimates? An Examination of the Joint Effects of Tone at the Top and Management's Specialist*, 95 *The Accounting Review* 367 (2020).

behaviors may be negatively associated with audit team leadership characteristics.⁴¹⁴ For example, skeptical auditors may be penalized if they do not find a material misstatement,⁴¹⁵ audit managers sometimes reward senior associates for performing the unethical act of under-reporting time when the client is more desirable,⁴¹⁶ or while internal inspections lead to increased auditor effort in the inspection year, positive internal inspection results may lead auditors to decrease effort in the future.⁴¹⁷

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.⁴¹⁸ In another study, audit staff report working on average 72 hours per week during busy season.⁴¹⁹ Other research finds that a heavier workload in the fieldwork phase of the audit is negatively associated with proxies for audit quality⁴²⁰ and that high levels of time pressure are positively associated with audit quality-threatening

⁴¹⁴ See, e.g., Noel Harding and Ken T. Trotman, *The Effect of Partner Communications of Fraud Likelihood and Skeptical Orientation on Auditors' Professional Skepticism*, 36 *Auditing: A Journal of Practice & Theory* 111 (2017); Sean A. Dennis and Karla M. Johnstone, *A Field Survey of Contemporary Brainstorming Practices*, 30 *Accounting Horizons* 449 (2016); Jodi L. Gissel and Karla M. Johnstone, *Information Sharing During Auditors' Fraud Brainstorming: Effects of Psychological Safety and Auditor Knowledge*, 12 *Current Issues in Auditing* P1 (2018).

⁴¹⁵ See, e.g., Brazel, et al., *The Outcome Effect*.

⁴¹⁶ See, e.g., Christopher P. Agoglia, Richard C. Hatfield, Tamara A. Lambert, *Audit Team Time Reporting: An Agency Theory Perspective*, 44 *Accounting, Organizations & Society* 1 (2015). Desirability in this case is determined by various situational and contextual factors that are inherent to the client, such as a client that is convenient for the audit manager's work schedule, a client that is easy to get to, client management that the audit manager gets along particularly well with personally, a client that is within the audit manager's industry of interest, or an engagement that involves an influential partner at the audit manager's office.

⁴¹⁷ See, e.g., Daniel Aobdia and Reining C. Petacchi, *The Effect of Audit Firm Internal Inspections on Auditor Effort and Financial Reporting Quality*, 98 *The Accounting Review* 1 (2023).

⁴¹⁸ See Julie S. Persellin, Jaime J. Schmidt, Scott D. Vandervelde, and Michael S. Wilkins, *Auditor Perceptions of Audit Workloads, Audit Quality, and Job Satisfaction*, 33 *Accounting Horizons* 95 (2019).

⁴¹⁹ See 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*, 10 *Current Issues in Auditing* A38 (2016).

⁴²⁰ 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*, 92 *Accounting, Organizations and Society* 1 (2021).

behaviors.⁴²¹ Referring to academic research, one commenter reported that engagement-level pressures, including meeting budgets, can affect audit quality.⁴²² The commenter also reported that academic research finds that audit partner workload compression is negatively associated with audit quality.⁴²³

One commenter noted academic papers that study various factors that may impact audit quality but appear to be too tangential or unrelated to quality-threatening behaviors that suggest certain weaknesses in QC systems. The commenter included academic research that studies the relationship between audit teams' use of the work of other participants and audit quality.⁴²⁴ The commenter also cited research from other countries that finds evidence that partner-related characteristics influence audit quality.⁴²⁵ In addition, the commenter noted

⁴²¹ See, e.g., Tobias Svanström, *Time Pressure, Training Activities and Dysfunctional Auditor Behaviour: Evidence from Small Audit Firms*, 20 *International Journal of Auditing* 42 (2016).

⁴²² See, e.g., Mark E. Peecher, M. David Piercey, Jay S. Rich, and Richard M. Tubbs, *The Effects of a Supervisor's Active Intervention in Subordinate's Judgments, Directional Goals, and Perceived Technical Knowledge Advantage on Audit Team Judgments*, 85 *Accounting Review* 1763 (2010); Koch and Salterio, *The Effects* 117; and William F. Messier and Martin Schmidt, *Offsetting Misstatements: The Effect of Misstatement Distribution, Quantitative Materiality, and Client Pressure on Auditors' Judgments*, 93 *Accounting Review* 335 (2018).

⁴²³ See, e.g., Jun Chen, Wang Dong, Hongling Han, and Nan Zhou, *Does Audit Partner Workload Compression Affect Audit Quality?* 29 *European Accounting Review* 1021 (2020).

⁴²⁴ See, e.g., Candice T. Hux, *Use of Specialists on Audit Engagements: A Research Synthesis and Directions for Future Research*, 39 *Journal of Accounting Literature* 23 (2017); Joseph F. Brazel, Tina D. Carpenter, and J. Gregory Jenkins, *Auditors' Use of Brainstorming in the Consideration of Fraud: Reports from the Field*, 85 *The Accounting Review* 1273 (2010); J. Gregory Jenkins, Eric M. Negangard, and Mitchell J. Oler, *Getting Comfortable on Audits: Understanding Firms' Usage of Forensic Specialists*, 35 *Contemporary Accounting Research* 1766 (2018); Emily E. Griffith, Jacqueline S. Hammersley, and Kathryn Kadous, *Audits of Complex Estimates as Verification of Management Numbers: How Institutional Pressures Shape Practice*, 32 *Contemporary Accounting Research* 833 (2015); Nathan H. Cannon and Jean C. Bedard, *Auditing Challenging Fair Value Measurements: Evidence from the Field*, 92 *The Accounting Review* 81 (2017); Steven M. Glover, Mark H. Taylor, and Yi-Jing Wu, *Current Practices and Challenges in Auditing Fair Value Measurements and Complex Estimates: Implications for Auditing Standards and the Academy*, 36 *Auditing: A Journal of Practice & Theory* 63 (2017); J. Efrim Boritz, Natalia Kochetova-Kozloski, and Linda Robinson, *Are Fraud Specialists Relatively More Effective than Auditors at Modifying Audit Programs in the Presence of Fraud Risk*, 90 *The Accounting Review* 881 (2015); Aleksandra "Ally" B. Zimmerman, Dereck Barr-Pulliam, Joon-Suk Lee, and Miguel Minutti-Meza, 61 *Journal of Accounting Research* 1363 (2023).

⁴²⁵ See, e.g., W. Robert Knechel, Ann Vanstraelen, and Mikko Zerni, *Does the Identity of Engagement Partners Matter? An Analysis of Audit Partner Reporting Decisions*, 32 *Contemporary Accounting Research* 1443 (2015); Yanyan Wang, Lisheng Yu, Yuping Zhao, *The Association between Audit-Partner Quality and Engagement Quality: Evidence from Financial Report Misstatements*, 34

academic papers that find evidence that non-audit services can negatively affect audit quality through mechanisms other than independence impairment.⁴²⁶ Moreover, the commenter included research that has examined the association between PCAOB inspections of audit firms and audit quality but does not appear to relate specifically to weaknesses in QC systems.⁴²⁷

5. Assumptions regarding the baseline

Absent the requirements, we believe that many firms would 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.⁴²⁸ We believe that most firms have either implemented ISQM 1 or will implement SQMS 1 when it goes into effect. 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.

Auditing: A Journal of Practice & Theory 81 (2015); W. Robert Knechel, Lasse Niemi, and Mikko Zerni, *Empirical Evidence on the Implicit Determinants of Compensation in Big 4 Audit Partnerships*, 51 *Journal of Accounting Research* 349 (2013); Simon Dekeyser, Ann Gaeremynck, W. Robert Knechel, and Marleen Willekens, *The Impact of Partners' Economic Incentives on Audit Quality in Big 4 Partnerships*, 96 *The Accounting Review* 129 (2021); Herman Van Brenk, Barbara Majoor, and Arnold M. Wright, *The Effects of Profit-Sharing Plans, Client Importance, and Reinforcement Sensitivity on Audit Quality*, 40 *Auditing: A Journal of Practice & Theory* 107 (2021).

⁴²⁶ See, e.g., Erik L. Beardsley, Andrew J. Imdieke, and Thomas C. Omer, *The Distraction Effect of Non-audit Services on Audit Quality*, 71 *Journal of Accounting and Economics* 1 (2021); Dain C. Donelson, Matthew Ege, Andrew J. Imdieke, and Eldar Maksymov, *The Revival of Large Consulting Practices at the Big 4 and Audit Quality*, 87 *Accounting, Organizations and Society* 1 (2020).

⁴²⁷ See, e.g., Daniel Aobdia, *The Impact of the PCAOB Individual Engagement Inspection Process—Preliminary Evidence*, 93 *The Accounting Review* 53 (2018); Inder K. Khurana, Nathan G. Lundstrom, and K.K. Raman, *PCAOB Inspections and the Differential Audit Quality Effect for Big 4 and Non-Big 4 US Auditors*, 38 *Contemporary Accounting Research* 376 (2021); Lindsay M. Johnson, Marsha B. Keune, and Jennifer Winchel, *U.S. Auditors' Perceptions of the PCAOB Inspection Process: A Behavioral Examination*, 36 *Contemporary Accounting Research* 1540 (2019); Kimberly D. Westermann, Jeffrey Cohen, and Greg Trompeter, *PCAOB Inspections: Public Accounting Firms on "Trial"*, 36 *Contemporary Accounting Research* 694 (2019); Bradley E. Hendricks, Wayne R. Landsman, and F. Peña-Romera, *The Revolving Door between Large Audit Firms and the PCAOB: Implications for Future Inspection Reports and Audit Quality*, 97 *The Accounting Review* 261 (2022).

⁴²⁸ See Section II.C above for additional background on the actions of other standard setters.

Supporting our view, comment letters on the proposing release suggest that some firms have already designed and implemented, or are in the process of designing and implementing, QC policies and procedures consistent with the requirements of other QC standards. For example, one commenter said that nearly all firms are subject to multiple QC standards, including ISQM 1. Another commenter said that firms in Europe have invested heavily to implement ISQM 1. Another commenter said that nearly all firms that will need to adopt QC 1000 are also subject to other QC standards, including ISQM 1 and SQMS 1, and that firms have already invested significant time and resources to comply with them. Another commenter presented its recent survey research that finds firms have started to prepare for ISQM 1 and SQMS 1 implementation but that there is variation in their level of preparedness.⁴²⁹ Overall, the comments indicate that firms have made progress implementing the quality control standards of other standard setters.

Our 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. 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.⁴³⁰ 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, which we believe 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, 2022, through March 31, 2023, 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 AICPA or IAASB QC standards during that time. Overall, we believe these public information sources support our 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 will likely be scaled-applicability firms and therefore less impacted by the requirements.

⁴²⁹ See Christie Hayne, Market E. Peecher, Jeff Pickerd, and Yuepin (Daniel) Zhou, *Managing Quality Control Systems: How Audit Firms Experience and Navigate Conflicting Institutional Demands*, available at <https://ssrn.com/abstract=4339512>.

⁴³⁰ See AICPA Peer Review webpage, available at <https://us.aicpa.org/interestareas/peerreview>.

B. Need

1. Introduction and summary

This section discusses the problem that the requirements are intended to address and explains how the requirements address it. Overall, three observations suggest that there is a problem that the requirements will help to address:

- Under current PCAOB QC standards, a firm’s QC system is required to provide reasonable assurance that the firm’s personnel comply with applicable professional standards, regulatory requirements, and the firm’s standards of quality.⁴³¹ However, the audit market does not currently provide sufficient incentives for all firms to design, implement, and operate QC systems that achieve this requirement on a consistent basis.
- Current PCAOB QC standards contain higher-level principles and do not directly address recent developments in QC. As a result, the current regulatory baseline is not rigorous enough to sufficiently support PCAOB oversight, further undermining firms’ and individuals’ incentives to provide the required reasonable assurance.
- The lack of incentives to provide the required reasonable assurance is evidenced by the prevalence of audit performance deficiencies—i.e., Part I.A deficiencies and QC deficiencies related to audit performance discussed in Section VI.A—which, as noted in the first two observations above, suggest that some firms’ QC systems are not providing the required reasonable assurance.

The requirements of QC 1000 will help address the problem by establishing three overarching features, which are discussed further in Section VI.B.5 below:

- The requirements mandate firms’ QC systems to more proactively assess risks and monitor and remediate deficiencies.
- The requirements improve accountability within firms with respect to the reasonable assurance objective.
- The requirements use more precise language and include more prescriptive requirements in key areas to reflect best practices.

⁴³¹ See Section II.A.2 for more discussion of current QC requirements.

2. The audit market does not provide sufficient incentives for all firms to design, implement, and operate QC systems that provide reasonable assurance

A diverse set of investors and other financial statement users need and request high quality audits. However, due to the presence of asymmetric information⁴³² and positive externalities⁴³³ in the audit market, there are not sufficient incentives for all firms to design, implement, and operate QC systems that provide reasonable assurance that a firm's personnel comply with applicable professional standards, regulatory requirements, and the firm's standards of quality. This lack of incentives can lead to an inefficient allocation of audit services as described in the following paragraphs.

Investors and other financial statement users cannot easily observe the services performed by an auditor. This information asymmetry creates a risk that, unbeknownst to investors and other financial statement users, auditors may under-audit and gather insufficient audit evidence to support their opinion or may otherwise depart from applicable requirements. Economic theory refers to this effect as moral hazard.⁴³⁴ 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 may also lead to a net welfare loss in the audit market as a whole.⁴³⁵

A positive externality inherent to the current audit market may exacerbate this risk. The services of an auditor provide benefits 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, Sarbanes-Oxley requires that the audit committee be responsible for the appointment,

⁴³² See N. Gregory Mankiw, *Principles of Economics* 468 (6th ed. 2008) ("A difference in access to relevant knowledge is called an information asymmetry.").

⁴³³ See Mankiw, *Principles of Economics* 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.").

⁴³⁴ See, e.g., Mankiw, *Principles of Economics* 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.").

⁴³⁵ See, e.g., Mankiw, *Principles of Economics* 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 the 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.").

compensation, and retention of the auditor.⁴³⁶ In practice, company management may also play a role through its influence over the audit committee.⁴³⁷ This 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.⁴³⁸ 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 particular 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.⁴³⁹ In addition, research suggests that an audit firm's QC system is essential to increase audit effort and audit quality because it aligns incentives of individual partners with those of the firm.⁴⁴⁰ 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.⁴⁴¹ One commenter presented its recent unpublished survey research regarding challenges firms face when implementing changes to their QC systems. The commenter reported that challenges include

⁴³⁶ See Section 301 of Sarbanes-Oxley, 15 U.S.C 78j-1.

⁴³⁷ See, e.g., Liesbeth Bruynseels and Eddy Cardinaels, *The Audit Committee: Management Watchdog or Personal Friend of the CEO?*, 89 *The Accounting Review* 113 (2014) (finding that social 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”).

⁴³⁸ See, e.g., Mankiw, *Principles of Economics* 200, 201 (“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.”).

⁴³⁹ See, e.g., Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 *Northwestern University Law Review* 133 (2000).

⁴⁴⁰ See, e.g., Daniel Aobdia, *The Economic Consequences of Audit Firms’ Quality Control System Deficiencies*, 66 *Management Science* 2883 (2019).

⁴⁴¹ See, e.g., Prentice, *The Case of the Irrational Auditor* 133, 162.

obtaining buy-in and acceptance from staff as well as managing different perspectives from various offices.⁴⁴²

Some firms may manage these challenges by adopting centralized control practices that may have ambiguous impacts on their QC systems. For example, academic research suggests that firms carefully screen new partners to act in the best interest of the firm⁴⁴³ and emphasize meeting engagement budgets—an easily monitored metric that ties directly to profitability.⁴⁴⁴ One commenter asserted that audit firms' financial incentives to operate too lean undermine audit quality. Investors and other financial statement users may have trouble monitoring how firms incentivize, implement, and monitor compliance with applicable professional requirements. These monitoring challenges, as well as the lack of specificity in current PCAOB QC standards, give firms the flexibility to design, implement, and operate QC systems that may not fully meet the needs of investors and other financial statement users.

In the absence of sufficient market incentives to achieve an efficient allocation of audit services,⁴⁴⁵ regulatory intervention can introduce incentives that generate changes in behavior and impact audit quality.⁴⁴⁶ For example, economic research suggests that auditing standards play a role in determining the amount of effort an auditor exerts, which ultimately impacts

⁴⁴² See Hayne, et al., *Managing Quality Control Systems*.

⁴⁴³ See, e.g., C. J. McNair, *Proper Compromises: The Management Control Dilemma in Public Accounting and its Impact on Auditor Behavior*, 16 *Accounting, Organizations and Society* 635 (1991).

⁴⁴⁴ See, e.g., Bernard Pierce and Breda Sweeney, *Cost–Quality Conflict in Audit Firms: An Empirical Investigation*, 13 *European Accounting Review* 415 (2004).

⁴⁴⁵ An efficient allocation of resources occurs when total surplus is maximized. Total surplus is maximized when the good or service in question is supplied until the marginal benefit is equal to the marginal cost. See Mankiw, *Principles of Economics* 146-148.

⁴⁴⁶ See, e.g., W. Robert Knechel, *Do Auditing Standards Matter?*, 7 *Current Issues in Auditing* A1 (2013) (explaining that auditing standards send a message to auditors that it is inappropriate to intentionally under-audit, regardless of incentives). We note that QC standards are not auditing standards but that auditing standards are a closely related form of regulatory intervention. We also note that academic research suggests that a positive association among standard setting, auditor effort, and audit quality depends on a number of factors. See, e.g., Pingyang Gao and Gaoqing Zhang, *Auditing Standards, Professional Judgment, and Audit Quality*, 94 *The Accounting Review* 201 (2019) (showing that auditing standards can help align auditor incentives with investor interests by compelling the auditor to exert more effort, which improves audit quality, but that auditing standards can weaken the auditor's incentive to acquire expertise, which reduces audit quality); Mark DeFond and Jieying Zhang, *A Review of Archival Auditing Research*, 58 *Journal of Accounting and Economics* 275 (2014) (concluding that the effectiveness of auditing standard setting is difficult to gauge since it involves broader consideration of the social welfare of all stakeholders).

audit quality.⁴⁴⁷ In addition, auditing standards can introduce incentives by providing a baseline against which an auditor manages legal liability.⁴⁴⁸ Auditing standards also provide a benchmark for regulatory inspections and enforcement actions that introduce incentives for firms to initiate changes that impact audit quality.⁴⁴⁹ Moreover, research suggests that PCAOB Part II inspection findings introduce strong incentives for firms to make changes necessary to remediate QC deficiencies in order to avoid public disclosure of the deficiencies.⁴⁵⁰

3. Current PCAOB QC standards do not directly address recent QC developments

Section II.B above discusses developments in the auditing environment since the development of the current PCAOB 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 current PCAOB 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.⁴⁵¹ There have also been significant developments in the

⁴⁴⁷ See, e.g., Marleen Willekens and Dan A. Simunic, *Precision in Auditing Standards: Effects on Auditor and Director Liability and the Supply and Demand for Audit Services*, 37 *Accounting and Business Research* 217 (2007) (showing that decreasing the precision of auditing standards initially incentivizes auditors to produce higher audit quality by exerting more effort but that decreasing precision beyond a certain point leads auditors to decrease effort).

⁴⁴⁸ See, e.g., Ronald A. Dye, *Auditing Standards, Legal Liability, and Auditor Wealth*, 101 *Journal of Political Economy* 887 (1993) (showing that an auditor who intends to comply with standards typically prefers higher standards when the auditor's personal wealth is observable by potential litigants but prefers lower standards when the auditor's wealth is unobservable); Causholli and Knechel, *An Examination of the Credence* 631 (explaining that regulation and litigation play an important role in shaping the audit process and an auditor's behavior); Knechel, *Do Auditing Standards A1* (explaining that auditing standards can influence the likelihood and extent of under-auditing by providing a basis for auditor liability that is an increasing function of the extent to which auditor effort falls short of the standard-compliant level).

⁴⁴⁹ See, e.g., Aobdia, *The Impact of the PCAOB Individual* 53 (finding that firms take corrective action on engagements with PCAOB Part I inspection findings and the effects spillover to non-inspected engagements); Phillip T. Lamoreaux, Michael Mowchan, and Wei Zhang, *Does Public Company Accounting Oversight Board Regulatory Enforcement Deter Low-Quality Audits?*, 98 *The Accounting Review* 335 (2023) (finding that large audit firm offices improve audit quality following enforcement naming another office within their firm while small firm offices improve following enforcement of local small firm competitors).

⁴⁵⁰ See, e.g., Aobdia, *The Economic Consequences* 2883.

⁴⁵¹ See Section VI.A.3 above.

use of technology by firms in relation to QC activities and performing engagements. Some firm management and organizational structures have also evolved to include more focus on centralization and a globally consistent methodology. Some firms have strengthened their approaches to firm governance and leadership, incentive systems, and accountability. In addition, thought leadership in quality management has advanced,⁴⁵² as have the QC standards adopted by other standard setters.

The current PCAOB QC standards are based on the higher-level principles described above in Section II.A.2 and Section IV and do not directly address the developments described in the previous paragraph. While research suggests that PCAOB oversight is associated with higher audit quality,⁴⁵³ the current PCAOB QC standards were not written with a view to inspection and enforcement by a regulator. As a result, the current PCAOB QC standards yield a regulatory baseline that is not rigorous enough to sufficiently support the Board's ability to address audit performance deficiencies through PCAOB inspection and enforcement activities related to firms' QC systems. For example, some firms have added external parties to oversight roles as described in Section II.B, but current PCAOB QC standards contain limited references to firm governance and leadership as described in Section IV.E.2. At the same time, the current PCAOB QC standards do not provide sufficiently specific requirements to directly incentivize firms and individuals to establish and implement QC policies and procedures that achieve the reasonable assurance objective as evidenced by the prevalence of audit performance deficiencies.

4. Prevalence of audit performance deficiencies

The three proxies for the level of compliance with applicable professional standards discussed in Section VI.A above—i.e., 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 are not providing reasonable assurance as required under current PCAOB QC standards.⁴⁵⁴ 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

⁴⁵² See, e.g., COSO, ISO 9000, and the audit firm governance codes of the UK Financial Reporting Council and Japan Financial Services Agency.

⁴⁵³ See, e.g., Albert L. Nagy, *PCAOB Quality Control Inspection Reports and Auditor Reputation*, 33 *Auditing: A Journal of Practice & Theory* 87 (2014) (concluding that audit firms lose market share following public disclosure of PCAOB Part II inspection findings, suggesting that disclosure provides a credible signal of auditor quality). We note that the results from this study that suggests a positive association between PCAOB oversight and audit quality does not necessarily mean that PCAOB oversight causes higher audit quality.

⁴⁵⁴ See Section II.A.2 for more discussion of current regulatory requirements.

their QC systems⁴⁵⁵ and that some firms have already reduced the number of QC deficiencies related to management of their audit practice.⁴⁵⁶ However, the Board continues to observe high rates of audit performance deficiencies⁴⁵⁷ and believes that a new QC standard will address these audit performance deficiencies because the new standard will incentivize firms to design, implement, and operate effective QC systems.

5. How the requirements address the need

The requirements provide substantial additional direction to firms regarding the design, implementation, and operation of their QC systems that we believe address the need for standard-setting. We describe below how three overarching features of the requirements help address the problem. The first feature pertains to the mandate for a more integrated, proactive, and risk-based QC system. The second pertains to the enhancements to accountability within the firm to achieve the reasonable assurance objective. The third pertains to more precise language and more prescriptive requirements in several key areas.

Regarding the first feature, the new risk assessment process, coupled with a detailed monitoring and remediation process, form a feedback loop designed to foster a proactive approach to QC that drives continuous improvement. For example, the risk assessment process requires 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 will 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 more consistently satisfy the interests of all beneficiaries of the audit. Additionally, as discussed above in Section VI.B.2, information asymmetry may cause investors and other financial statement users 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 and other financial statement users 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 substitutes a compliance incentive for the insufficient market incentive.

Regarding the second feature, we believe QC 1000 will improve accountability within the firm to achieve the reasonable assurance objective. Several of the requirements that improve accountability within the firm address the positive externality problem directly by leading firms to implement QC systems that more consistently satisfy the interests of all

⁴⁵⁵ This point is discussed more fully in Section VI.C.1 below.

⁴⁵⁶ See Figure 5 in Section VI.A.3.

⁴⁵⁷ See Figures 1 and 3 in Section VI.A.1.

beneficiaries of the audit. For example, QC 1000 requires 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, through means such as performance evaluations and compensation. Leadership will also be accountable for the design, implementation, and operation of the firm's QC system, including through means such as their performance evaluation and compensation, and the firm will 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. The requirements that improve accountability within the firm will help address the information asymmetry problem by requiring the firm's QC system to operate over any public reporting regarding firm or engagement metrics that the firm provides.⁴⁵⁸ Overall, this second feature reinforces the first through an additional incentive that is personal to responsible individuals within the firm and reinforces the general incentives for the firm to comply with the standard.

Regarding the third feature, while the requirements provide substantial additional guidance to firms regarding the design, implementation, and operation of their QC systems, QC 1000 also provides more precise and prescriptive requirements that will enhance the Board's ability to inspect and enforce and incentivize firms to design, implement, and operate effective QC systems. For example, QC 1000 includes more unconditional responsibilities than current PCAOB QC standards and specifies precise conditions under which a firm must design, implement, and operate an effective QC system. Together with the features described above—i.e., a more integrated, proactive, and risk-based QC system and enhanced accountability within the firm to achieve the reasonable assurance objective—these features establish a regulatory baseline that more directly incentivizes firms and individuals to comply in order to avoid enforcement.

C. Economic Impacts

This section discusses the expected benefits and costs, and the potential unintended consequences, that may result from the requirements. We highlight the expected impacts of several key provisions. These provisions relate to:

- Scaled applicability;
- In-process monitoring activities;
- Firm governance structure;
- The automated independence process;

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See PCAOB Rel. No. 2024-002 and PCAOB Rel. No. 2024-003.

- Complaints and allegations policies and procedures;
- 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 due to data limitations, the analysis does, in part, use PCAOB inspections data to help evaluate the expected benefits. Technical details regarding the quantitative analysis of the expected benefits are included in a separate staff white paper.⁴⁵⁹

The economic impacts of the requirements will arise out of changes firms will make to their QC systems that they would not otherwise make but for the requirements. As discussed in Section VI.A. above, we expect that, absent the 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 attenuates both the benefits and the costs attributable to the requirements.

1. Benefits

We describe the expected benefits of the requirements using four complementary views: (1) the benefits of quality management frameworks generally; (2) the direct benefits of the requirements in the form of improved compliance with applicable professional and legal requirements; (3) the indirect benefits of the requirements in the form of improved financial reporting quality and capital market efficiency; and (4) the benefits of key provisions.

a. Benefits of related frameworks

QC 1000 bears resemblance to existing quality management and enterprise risk management frameworks (e.g., ISO 9000 and COSO). These frameworks share several features in common with QC 1000, 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

⁴⁵⁹ See PCAOB, *Staff White Paper, The Impact of Quality Control System Remediation on Audit Performance and Financial Reporting Quality* (Nov. 18, 2022), (“QC White Paper”), available at https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket046/qc-staff-white-paper-november-2022.pdf?sfvrsn=ddb22504_4.

that these frameworks improve company performance.⁴⁶⁰ In particular, researchers have found that the COSO framework—the closest antecedent to QC 1000—effectively improves financial reporting.⁴⁶¹ Similarly, research finds that markets penalize public companies with weaker internal control systems and reward the remediation of those weaknesses.⁴⁶² While differences between QC 1000 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 QC 1000 may help firms design, implement, and operate more effective QC systems.

b. Improved compliance with applicable professional and legal requirements

We expect the requirements will benefit investors and other financial statement users by improving compliance with applicable professional and legal requirements via a more detailed QC standard. As described in Section VI.B.5 above, the requirements are expected to achieve this through three principal mechanisms. First, they 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 will support the effectiveness of QC systems by emphasizing accountability to the reasonable assurance objective. Third, more precise and prescriptive requirements will enhance the Board’s ability to inspect and enforce. Broker-dealer engagements and issuer audits performed by firms other than U.S. GNFs may see more improvement because they appear to have more room for improvement on average. However, the recent uptick in deficiencies for U.S. GNFs suggests that QC 1000 will also be a valuable resource for these firms to address those deficiencies and, thus, further protect investors.⁴⁶³

Some commenters described how a risk-based QC standard would improve audit quality. However, one commenter argued that the requirements are too risk-based (e.g., they could result in too little change at the larger firms) and suggested an even stronger prescriptive approach to certain aspects of the standard (e.g., training and supervision). We believe the

⁴⁶⁰ See, e.g., Iñaki Heras-Saizarbitoria and Olivier Boiral, *ISO 9001 and ISO 14001: Towards a Research Agenda on Management System Standards*, 15 *International Journal of Management Reviews* 47 (2013); Robert E. Hoyt and Andre P. Liebenberg, *The Value of Enterprise Risk Management*, 78 *Journal of Risk and Insurance* 795 (2011).

⁴⁶¹ See, e.g., Hanwen Chen, Wang Dong, Hongling Han, and Nan Zhou, *A Comprehensive and Quantitative Internal Control Index: Construction, Validation, and Impact*, 49 *Review of Quantitative Finance and Accounting* 337 (2017); Ifeoma Udeh, *Observed Effectiveness of the COSO 2013 Framework*, 16 *Journal of Accounting & Organizational Change* 31 (2020).

⁴⁶² See, e.g., Hollis Ashbaugh-Skaife, Daniel W. Collins, William R. Kinney, Jr., and Ryan Lafond, *The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity*, 47 *Journal of Accounting Research* 1 (2009).

⁴⁶³ See Section VI.A.1.

standard reflects a balanced approach that includes prescriptive requirements where appropriate.

Staff analysis of PCAOB inspections data supports the view that more effective QC policies and procedures will lead to improved compliance with applicable professional and legal requirements. Staff examined the historical association between satisfactory remediation of QC deficiencies and subsequent Part I.A deficiencies for triennial firms. Satisfactory remediation of a QC deficiency reflects substantial good-faith progress toward achieving a quality control objective.⁴⁶⁴ 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 and legal requirements. 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 and legal requirements.⁴⁶⁵ One commenter reported observing that satisfactory remediation of QC deficiencies results in fewer audit failures and asserted that this was in line with certain key findings of the staff analysis.

The staff analysis is subject to several important caveats. First, remedial actions typically target specific aspects of a firm's QC system. By contrast, implementation of QC 1000 may require a broader set of changes. Second, due to the transformational nature of QC 1000, the changes firms will 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 practice⁴⁶⁶ and U.S. GNFs' compliance with applicable professional standards⁴⁶⁷ suggests that, even among the U.S. GNFs, more effective QC systems could lead to improved compliance with applicable professional and legal requirements.⁴⁶⁸

⁴⁶⁴ See *Staff Guidance Concerning the Remediation Process* (Nov. 18, 2013), available at https://pcaobus.org/Inspections/Pages/Remediation_Process.aspx.

⁴⁶⁵ For additional details, including definitions of all control variables, see QC White Paper.

⁴⁶⁶ See Figure 5 in Section VI.A.3 above.

⁴⁶⁷ See Figures 1 and 3 in Section VI.A.1 above.

⁴⁶⁸ 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

Overall, we expect the association between satisfactory remediation and subsequent Part I.A deficiencies among triennial firms more likely understates the impact of QC 1000 due to its transformational nature.

Observations from PCAOB inspections and academic research also suggest that the requirements may improve compliance with applicable professional and legal requirements. 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,⁴⁶⁹ and one academic study reports that, as perceptions of the strength of the QC system increase, the likelihood of "reduced audit quality behaviors" decreases.⁴⁷⁰ These findings likewise support the view that the requirements, which place greater emphasis on root cause analysis, remediation, and governance practices, if successfully implemented, will lead to improved compliance with applicable professional and legal requirements.

c. Improved financial reporting quality and capital market efficiency

Academic research provides evidence that compliance with auditing standards is positively associated with proxies for financial reporting quality.⁴⁷¹ Research also finds a positive association between firms' successful remediation of QC deficiencies—a proxy for adopting effective QC system practices—and the financial reporting quality of their issuer clients.⁴⁷² Staff analysis also provides some evidence that successful remediation may be associated with improved financial reporting quality.⁴⁷³ We note that the results from each of these studies that suggest a positive association with financial reporting quality does not necessarily mean that auditing standards or remediation of deficiencies cause better financial reporting quality.

Investors and other financial statement users may benefit from improved issuer financial reporting quality because it helps solve information asymmetries and agency problems

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.

⁴⁶⁹ See, e.g., 2018 Inspection Observations Preview.

⁴⁷⁰ See, e.g., Charles F. Malone and Robin W. Roberts, *Factors Associated with the Incidence of Reduced Audit Quality Behaviors*, 15 *Auditing: A Journal of Practice & Theory* 49 (1996).

⁴⁷¹ See, e.g., Daniel Aobdia, *Do Practitioner Assessments Agree with Academic Proxies for Audit Quality? Evidence from PCAOB and Internal Inspections*, 67 *Journal of Accounting and Economics* 144 (2019); Katherine A. Gunny and Tracey Chunqi Zhang, *PCAOB Inspection Reports and Audit Quality*, 32 *Journal of Accounting and Public Policy* 136 (2013).

⁴⁷² See, e.g., Aobdia, *The Economic Consequences* 2883.

⁴⁷³ See QC White Paper.

inherent to capital markets. Economic theory suggests that investors face a separation-of-ownership-and-control problem whereby issuer management may misappropriate investors' capital.⁴⁷⁴ 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 more accurately identify companies with the strongest prospects for generating future risk-adjusted returns and allocate their capital accordingly). 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.⁴⁷⁵ While some uncertainty remains regarding the economic impacts of financial reporting,⁴⁷⁶ empirical academic research has affirmed this basic premise under certain conditions.⁴⁷⁷ Moreover, some

⁴⁷⁴ See, e.g., Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *Journal of Financial Economics* 305 (1976); Adolf Augustus Berle and Gardiner Coit Means, *The Modern Corporation and Private Property* (1991).

⁴⁷⁵ See, e.g., Richard Lambert, Christian Leuz, and Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, 45 *Journal of Accounting Research* 385, 387 (2007) (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); William Robert Scott and Patricia C. O'Brien, *Financial Accounting Theory* (2003), 412 (explaining that regulation is intended to improve the operation of capital markets by enhancing public confidence in their fairness).

⁴⁷⁶ See, e.g., Christian Leuz and Peter D. Wysocki, *The Economics of Disclosure and Financial Reporting Regulation: Evidence and Suggestions for Future Research*, 54 *Journal of Accounting Research* 525 (2016) (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).

⁴⁷⁷ See, e.g., Christian Leuz and Robert E. Verrecchia, *The Economic Consequences of Increased Disclosure*, 38 *Journal of Accounting Research* 91 (2000) (finding that German companies that elect to commit to International Accounting Standards or U.S. GAAP exhibit lower percentage bid-ask spreads and higher share turnover than firms using German GAAP); Utpal Bhattacharya, Hazem Daouk, and Michael Welker, *The World Price of Earnings Opacity*, 78 *The Accounting Review* 641 (2003) (finding that an increase in overall earnings opacity in a country is linked to an economically significant increase in the cost of equity and an economically significant decrease in trading in the stock market of that country based on financial statements from 34 countries for the period 1984-1998). We note that because U.S. institutions differ from other countries and the studies pre-date Sarbanes-Oxley, the results may not be directly relevant to all PCAOB-registered firms.

studies have identified a direct association between auditors' compliance with PCAOB standards and capital market efficiency.⁴⁷⁸

The requirements may also lead to improved compliance with applicable professional and legal requirements on broker-dealer audit engagements and, in turn, improved 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 will maintain appropriate controls over compliance and less likely that there will be material reporting errors. The auditor's work 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 applicable professional and legal requirements 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

i. Scaled applicability

QC 1000 will 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 thereafter through the next September 30.⁴⁷⁹ Section III.C.1 above provides further information on this provision. As of June 30, 2023, up to 60% of firms may not meet this criterion but will be required to design a QC system in compliance with QC 1000.⁴⁸⁰ Because registering with the PCAOB enables a firm to issue audit

⁴⁷⁸ See, e.g., Nemit Shroff, *Real Effects of PCAOB International Inspections*, 95 *The Accounting Review* 399 (2020).

⁴⁷⁹ See QC 1000.07.

⁴⁸⁰ The 60% reported here is based on Form 2 reporting as of June 30, 2023, and reflects registered firms that reported 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. As noted in Section III.C, approximately 51% of firms have not performed an engagement under PCAOB standards for an issuer or broker-dealer in the past five years. We do not collect information about whether registered firms perform engagements under PCAOB standards other than for issuers and broker-dealers. Firms

reports or play a substantial role on audits performed under PCAOB standards for issuers and broker-dealers, and because investors and companies considering engaging the firm 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 promotes our mission of protecting investors and promoting the public interest. We also believe that designing the QC system will better position these firms to accept and perform engagements in compliance with applicable professional and legal requirements to the extent that the firm will have a PCAOB-compliant QC system ready for implementation and operation.

ii. In-process monitoring activities

QC 1000 will require firms that issued audit reports with respect to more than 100 issuers during the prior calendar year to monitor in-process engagements and will require all other firms to consider monitoring in-process engagements.⁴⁸¹ Section IV.K.1.c.ii above provides further information on this provision. 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 that has the potential to benefit investors through improved audit quality. The benefits will depend on the extent to which firms already have in-process monitoring activities in place. Information gathered through PCAOB inspection activities indicates that 11 out of 14 annually inspected firms perform some in-process engagement monitoring activities.

iii. Firm governance structure

QC 1000 will 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 external oversight function for the QC system composed of one or more persons who are not principals or employees of the firm and do 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 (i.e., EQCF).⁴⁸² The final standard specifies a baseline requirement that the EQCF's responsibilities should include, at a minimum, evaluating the significant judgments made and the related conclusions reached by the firm when evaluating and reporting on the effectiveness of its QC system. Section IV.E.1.b above provides

may be engaged, 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.

⁴⁸¹ See QC 1000.63.

⁴⁸² See QC 1000.28.

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 and other financial statement users. Some academic research finds that the level of board of directors independence is associated with certain benefits, such as improved operating performance and company value, which implies independent oversight in a firm's governance structure could potentially improve the quality of audit services provided by the firm.⁴⁸³

iv. The automated independence process

QC 1000 will require firms that issued audit reports with respect to more than 100 issuers during the prior calendar year to automate the process to identify investments in securities that might impair the independence of the firm or firm personnel that are managerial employees or partners, shareholders, members, or other principals.⁴⁸⁴ Section IV.F.1.b.ii.1 above provides further information on this provision. Automating this process should help firms more effectively and efficiently identify such investments. The automated process could also indirectly improve compliance with other relevant independence requirements. For example, automating this process may lead firms to maintain and make available the list of restricted entities more efficiently and effectively.

v. Complaints and allegations policies and procedures

QC 1000 will require firms to design, implement, and maintain policies and procedures that address processes and responsibilities for receiving, investigating, and addressing complaints and allegations and include protecting persons making complaints and allegations from retaliation.⁴⁸⁵ Firms that issued audit reports with respect to more than 100 issuers during the prior calendar year will be required to include confidentiality protections in their policies and procedures. Section IV.E.1.b above provides further information on this provision. Overall, we expect the policies and procedure regarding complaints and allegations will help reduce information asymmetry within the firm by alerting responsible individuals to instances of non-compliance of which they may otherwise be unaware. Some academic research suggests that the complaints and allegations provisions will increase the likelihood that individuals will submit complaints and allegations related to potential non-compliance. For example, one survey of

⁴⁸³ See, e.g., Anzhela Knyazeva, Diana Knyazeva, and Ronald W. Masulis, *The Supply of Corporate Directors and Board Independence*, 26 *The Review of Financial Studies* 1561 (2013). Other academic research indicates that a tradeoff of more independent board of directors may be less efficient monitoring by directors. See, e.g., Praveen Kumar and K. Sivaramakrishnan, *Who Monitors the Monitor? The Effect of Board Independence on Executive Compensation and Firm Value*, 21 *The Review of Financial Studies* 1371 (2008).

⁴⁸⁴ See QC 1000.34a.

⁴⁸⁵ See QC 1000.29.

public company auditors finds that (1) greater protection of individual identity and (2) trust that the firm would investigate and act on a report are both positively associated with intention to report non-compliance with auditing standards.⁴⁸⁶ A survey of accounting students finds that a weaker threat of retaliation is positively associated with the propensity to submit a complaint.⁴⁸⁷ We acknowledge that some experimental research finds that explicit protections may unintentionally deter internal complaints and allegations because the protections signal to potential persons making complaints that retaliation is a risk.⁴⁸⁸ However, overall, we expect the complaints and allegations provisions will benefit investors by reducing non-compliance with auditing standards and, thus, improving audit quality.

vi. Reporting the annual QC system evaluation

QC 1000 will require firms to report to the PCAOB about the annual evaluation of their QC system.⁴⁸⁹ Section IV.L.1.c above provides further information on this provision. This requirement will 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 will use this information to support its oversight activities (e.g., to select firms, audits, or focus areas for review). Reporting to the PCAOB will also improve incentives within a firm to design, implement, and operate an effective QC system.

vii. Certification of the annual QC system evaluation

QC 1000 will require certain individuals in firms' leadership to certify the annual evaluation of their firm's QC system.⁴⁹⁰ Section IV.L.1.c.iii above provides further information on this provision. This requirement will help address the positive externality problem in the audit market by creating greater accountability within firm leadership to implement an effective QC system. As noted in the proposal, PCAOB staff reviewed academic literature on the impacts of CEO and CFO certification requirements in the U.S. and engagement partner signature requirements in the United Kingdom and found both supportive and unsupportive

⁴⁸⁶ See Mary B. Curtis and Eileen Z. Taylor, *Whistleblowing in Public Accounting: Influence of Identity Disclosure, Situational Context, and Personal Characteristics*, 9 *Accounting and the Public Interest* 191 (2009).

⁴⁸⁷ See Gregory Liyanarachchi and Chris Newdick, *The Impact of Moral Reasoning and Retaliation on Whistle-Blowing*, 89 *Journal of Business Ethics* 37 (2009).

⁴⁸⁸ See James Wainberg and Stephen Perreault, *Whistleblowing in Audit Firms: Do Explicit Protections from Retaliation Activate Implicit Threats of Reprisal?*, 28 *Behavioral Research in Accounting* 83 (2016).

⁴⁸⁹ See QC 1000.79.

⁴⁹⁰ See QC 1000.14d. and .15b.

findings.⁴⁹¹ One commenter noted academic research that has found there is little, if any, effect of CEO and CFO certifications required under Sarbanes-Oxley.⁴⁹² Citing academic literature on accountability frameworks, the same commenter noted that imposition of accountability is largely positive⁴⁹³ but that the increased accountability that would result from the certification requirement could have negative consequences.⁴⁹⁴ As discussed in Section VI.C.3 below, we

⁴⁹¹ See, e.g., Daniel A. Cohen, Aiysha Dey, and Thomas Z. Lys, *Corporate Governance Reform and Executive Incentive: Implications for Investments and Risk Taking*, 30 *Contemporary Accounting Research* 1298 (2013) (finding that their sample of firms significantly reduced investments in risky projects in the period following SOX); 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?*, 81 *The Accounting Review* 1, 22 (2006) (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); Jeffrey R. Cohen, Colleen Hayes, Ganesh Krishnamoorthy, Gary S. Monroe, and Arnold M. Wright, *The Effectiveness of SOX Regulation: An Interview Study of Corporate Directors*, 25 *Behavioral Research in Accounting* 61 (2013) (discussing that CEO certification was viewed as having led to heightened ownership and diligence on the part of decision agents throughout the financial reporting decision hierarchy but was also identified as a source of the costly resource-intensive reaction to Sarbanes-Oxley).

⁴⁹² See, e.g., Paul A. Griffin and David H. Lont, *Taking the Oath: Investor Response to SEC Certification Under Sarbanes-Oxley*, 1 *Journal of Contemporary Accounting & Economics* 27 (2005); Gerald J. Lobo and Jian Zhou, *Did Conservatism in Financial Reporting Increase after the Sarbanes-Oxley Act? Initial Evidence*, 20 *Accounting Horizons* 57 (2006); Utpal Bhattacharya, Peter Groznik, and Bruce Haslem, *Is CEO Certification of Earnings Numbers Value-Relevant?*, 14 *Journal of Empirical Finance* 611 (2007).

⁴⁹³ See, e.g., Andrew Quinn and Barry R. Schlenker, *Can Accountability Produce Independence? Goals as Determinants of the Impact of Accountability on Conformity*, 28 *Personality and Social Psychology Bulletin* 472 (2002); Virginia R. Stewart, Deirdre G. Snyder, and Chia-Yu Kou, *We Hold Ourselves Accountable: A Relational View of Team Accountability*, 183 *Journal of Business Ethics* 691 (2023); Angela T. Hall, Michael G. Bowen, Gerald R. Ferris, M. Todd Royle, Dale E. Fitzgibbons, *The Accountability Lens: A New Way to View Management Issues*, 50 *Business Horizons* 405 (2007); Marko Pitesa and Stefan Thau, *Masters of the Universe: How Power and Accountability Influence Self-Serving Decisions under Moral Hazard*, 98 *Journal of Applied Psychology* 550 (2013); Constantine Sedikides, Deletha Hardin, Kenneth Herbst, and Gregory Dardis, *Accountability as a Deterrent to Self-Enhancement: The Search for Mechanisms*, 83 *Journal of Personality & Social Psychology* 592 (2002).

⁴⁹⁴ See, e.g., Jennifer J. Dose and Richard J. Klimoski, *Doing the Right Thing in the Workplace: Responsibility in the Face of Accountability*, 8 *Employee Responsibilities & Rights Journal* 35 (1995); Jennifer S. Lerner and Philip E. Tetlock, *Accounting for the Effects of Accountability*, 125 *Psychological Bulletin* 255 (1999); Randall A. Gordon, Richard M. Rozelle, and James C. Baxter, *The Effect of Applicant Age, Job Level, and Accountability on Perceptions of Female Job Applicants*, 123 *Journal of Psychology* 59 (1989); Philip E. Tetlock, *The Impact of Accountability on Judgment and Choice: Toward a Social Contingency Model*, 25 *Advances in Experimental Social Psychology* 331 (1992); Angela T. Hall, Dwight D. Frink, and M. Ronald Buckley, *An Accountability Account: A Review and Synthesis of the Theoretical and*

acknowledge that increased accountability could lead to potential unintended consequences. However, we continue to believe that the certification requirement will benefit investors by increasing discipline in the evaluation process and reinforcing the accountability of the certifying individuals.

viii. Responding to engagement deficiencies identified after issuance of the audit report

The amendments to AS 2901, *Consideration of Omitted Procedures After the Report Date*, include: (1) addressing engagement deficiencies in addition to omitted procedures and (2) including the ICFR audit within its scope. Relatedly, the amendments to AT No. 1 and AT No. 2 mirror the amendments to AS 2901. Section V.A.2 above provides further information on this provision. We expect these amendments will 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 reports in the case of review engagements) that are being relied on. In such cases, PCAOB standards will 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 will be valuable to capital market participants with improvements in company performance and financial reporting.⁴⁹⁵

ix. SECPS requirements

The requirements will refine, integrate into QC 1000, 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, provides an overview of these requirements. We expect that this feature of the rulemaking will benefit investors by enhancing audit quality through improved compliance with SEC and PCAOB independence rules on

Empirical Research on Felt Accountability, 38 *Journal of Organizational Behavior* 204 (2017); Sheldon Adelberg and Daniel C. Batson, *Accountability and Helping: When Needs Exceed Resources*, 36 *Journal of Personality and Social Psychology* 343 (1978); Mark E. Peecher, Ira Solomon, and Ken T. Trotman, *An Accountability Framework for Financial Statement Auditors and Related Research Questions*, 38 *Accounting, Organizations and Society* 596 (2013); Angela T. Hall, M. Todd Royle, Robert A. Brymer, Pamela L. Perrewé, Gerald R. Ferris and Wayne A. Hochwarter, *Relationships Between Felt Accountability as a Stressor and Strain Reaction: The Neutralizing Role of Autonomy Across Two Studies*, 11 *Journal of Occupational Health Psychology* 87 (2006).

⁴⁹⁵ See Section VI.C.1.a above and the research cited therein.

engagements performed by firms not already subject to these requirements under PCAOB Rule 3400T.

2. Costs

We expect the requirements will result in additional direct and indirect costs to auditors and, potentially, indirect costs to the companies that they audit. The extent of these costs will depend on the degree to which firms otherwise have QC systems in place designed to comply with other QC standards and the specific policies and procedures adopted by the firm. 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 utilized in the areas of independence, ethics, and resources. As discussed in Section VI.A.5 above, we believe most firms are subject to other QC standards. In designing, implementing, and operating their QC systems, firms that are subject to both PCAOB standards and other QC standards can leverage the investments they make to comply with the requirements of the other standards. Therefore, we expect that a portion of the overall costs of designing, implementing, and operating policies and procedures to comply with QC 1000 have been or will be incurred by most firms regardless of whether QC 1000 is adopted. As a consequence, for most firms, we expect the costs discussed below will derive primarily from the provisions in QC 1000 that go beyond the requirements of other QC standards.

Several commenters noted there will be costs and challenges to implement and operate features of QC 1000 that are incremental to the systems firms have established to comply with other QC standards. One commenter said that the need to accommodate nuances among different standards results in firms maintaining different methodologies, practices, and procedures that puts pressure on limited firm resources. Several commenters asserted that firms that audit between 100 and 500 issuers will be significantly impacted by costs associated with some or all of QC 1000's incremental requirements for firms that issue audit reports for more than 100 issuers, and some of the commenters noted resource differences between GNFs and annually-inspected NAFs. Since QC systems are resource-intensive, the efforts required to respond to the additional provisions in QC 1000 or to otherwise adapt the QC system to the auditing environment for issuers and SEC-registered broker-dealers could be significant.

While we lack data to quantify the costs that could result from QC 1000, some studies have estimated costs associated with ICFR under Sarbanes-Oxley Section 404.⁴⁹⁶ We

⁴⁹⁶ Based on a sample of companies that voluntarily disclosed Section 404 cost information in their SEC filings during the period January 2003 to September 2005, one study found that the mean total compliance costs for Section 404 was \$2.2 million (\$3.7 million adjusted for inflation), and the median was \$1.2 million (\$2.0 million adjusted for inflation). See Jagan Krishnan, Dasaratha Rama, and Yinghong Zhang, *Costs to Comply with SOX Section 404*, 27 *Auditing: A Journal of Practice & Theory* 169 (2008).

acknowledge differences between Section 404 and QC 1000, but Section 404 is similar to QC 1000 in that Section 404 was a policy shock that led large public companies to improve their internal control practices. In addition, while QC 1000 is not an internal control framework *per se*, it does reflect similar principles as COSO, the industry standard control framework that was widely relied upon to implement Section 404. One commenter observed that the requirements under QC 1000 are similar in certain ways to the requirements related to ICFR under Sarbanes-Oxley for companies and suggested that the impacts of QC 1000 on auditors will be similar to the impact Sarbanes-Oxley had on companies notwithstanding key differences between a company's ICFR and an audit firm's QC system.

a. Direct and indirect costs of the proposed requirements

We expect the requirements will lead to several direct and indirect costs. There will be a direct cost to audit firms to design a QC system that complies with QC 1000. For example, firms will likely spend time reviewing QC 1000; assigning roles and responsibilities; identifying staffing and training needs; and developing a set of quality objectives, quality risks, and quality responses. Once a QC system is designed, firms will incur costs 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. Some firms may outsource certain aspects of QC system design. We also expect that customization will be necessary to ensure that each QC system design appropriately addresses each firm's circumstances. The extent of the design costs will likely depend on facts and circumstances unique to each firm. Among firms that will be subject to other QC standards, which we believe represents most firms, the design

Using a sample of Fortune 1000 companies, another study estimated the companies spent an average of \$5.9 million (\$9.6 million adjusted for inflation) to comply with Section 404 in the first year of implementation. See Charles River Associates, *Sarbanes-Oxley 404 Costs and Remediation of Deficiencies: Estimates from a Sample of Fortune 1000 Companies* (2005). Another study found that direct costs of Section 404 fell by as much as 40% by the second year after implementation and varied significantly by company size. See John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 *Journal of Economic Perspectives* 91 (2007). Another study reported an SEC survey sample that showed an overall average Section 404 compliance expense of \$1.2 million (\$1.7 million adjusted for inflation) in the latest fiscal year before the survey (December 2008-January 2009) and respondents reported a decline over time in such costs. See Cindy R. Alexander, Scott W. Bauguess, Gennaro Bernile, Yoon-Ho Alex Lee, and Jennifer Marietta-Westberg, *Economic Effects of SOX Section 404 Compliance: A Corporate Insider Perspective*, 56 *Journal of Accounting and Economics* 273 (2013). To adjust results from the studies for inflation, PCAOB staff used an inflationary factor as of the third quarter 2023 from the current dollar index number of the Employment Cost Index for private workers employed in the professional, scientific, and technical services industry published by the U.S. Bureau of Labor Statistics (available at <https://www.bls.gov/eci/data.htm>). This inflationary adjustment does not account for any potential differences between QC 1000 costs and Section 404 costs or any potential structural changes over time.

costs will likely be reduced and limited to incremental requirements around ethics, independence, monitoring, and remediation.

For full applicability firms—those that will be required to implement and operate an effective QC system—there will likely be additional costs. Firms may need to implement 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 called for an extended implementation period due to these costs. Describing the results of its recent survey of assurance service QC leaders, one commenter reported that obtaining “buy in” and acceptance from organizational members is the most common challenge firms face when implementing changes to their QC systems.⁴⁹⁷ As discussed, we agree there will be implementation costs; however, these implementation costs will be reduced to the extent that firms already implement the requirements to comply with the actions of other standard setters or due to other developments. Furthermore, we expect the design and implementation costs will be largely fixed in nature and will decline 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, report the results of the evaluation to the PCAOB using the same PCAOB platform as our other reporting forms, and prepare and retain the required documentation. Several commenters identified significant operating costs. For example, one commenter argued that the proposed independent oversight function could entail insurance costs. 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 will be reduced for firms that would be subject to other standard setters or other developments.

Several commenters asserted that the documentation costs, as originally proposed, could be particularly onerous. For example, several commenters asserted that firms would be required to retain large volumes of documentation to support the operation of the firm’s quality responses for each instance related to all years for which firms are required to maintain such documentation. One commenter noted that information evidencing the operation of a firm’s QC system can vary in size, type, and storage requirements and that the costs of modifying the firm’s existing IT systems to comply with the documentation requirement could be significant. Some commenters noted that the amount of documentation to be retained is expected to require considerably more storage space for each evaluation period, which the commenters suggested translates to a need for new servers and extended licensing

⁴⁹⁷ See Hayne, et al., *Managing Quality Control Systems*.

agreements. One commenter said that firms that change their systems will have to maintain licenses for old systems for up to seven years. The same commenter said the seven-year retention period goes well beyond the retention requirements of ISQM 1 and SQMS 1 and asserted that firms with a significant private company client base would be challenged to have different documentation retention policies since many aspects of quality control relate to the firm as a whole. Some commenters suggested that retaining sensitive information introduces heightened cybersecurity risks for firms, firm personnel, clients, and other stakeholders. We acknowledge that the documentation requirement could create costs for firms, including costs related to retention and cybersecurity infrastructure. To clarify the expected cost burden, we have noted in Section IV.M.1 that documentation of every aspect of the operation of the firm's QC system may not be required to evidence that each quality response operated effectively.

Several commenters asserted that smaller firms may be especially affected by the new QC requirements, including requirements incremental or alternative to ISQM 1 and SQMS 1. One commenter said that smaller firms will need to hire consultants or additional staff for the monitoring, remediation, and evaluation functions, notwithstanding the scalability of QC 1000. Another commenter asserted that QC 1000 will impose disproportionate costs on smaller firms but noted that the commenter did not analyze in detail the cost of each incremental requirement and therefore did not have an estimate of the disproportionate costs. Relatedly, research finds that implementation and operating costs of internal control frameworks precipitated by Sarbanes-Oxley are proportionally greater for smaller companies.⁴⁹⁸

We acknowledge that the direct costs will likely vary depending on the size of the firm and the nature of its audit practice. Larger PCAOB audit practices 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, which would decrease the cost of QC 1000 per engagement. Larger PCAOB audit practices will be able to distribute fixed implementation costs over a larger number of engagements, while smaller practices will distribute fixed implementation costs over a smaller 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 PCAOB audit practices—to implement effective QC systems. To the extent that smaller firms may be disproportionately impacted as commenters have suggested, we continue to believe that the principles-based features and scalable nature of QC 1000, described in greater detail above in Section III.C, as well as the 100-issuer threshold for some provisions, help to mitigate their costs because smaller firms will rely on proportionally fewer resources for design, implementation, and operation of their QC systems.

In addition to the direct costs to auditors to comply with the requirements, indirect costs may arise. To the extent that compliance with the requirements will improve compliance

⁴⁹⁸ See, e.g., John C. Coates and Suraj Srinivasan, *SOX after Ten Years: A Multidisciplinary Review*, 28 *Accounting Horizons* 627 (2014).

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 previously did. However, firms should be incurring these costs already.

Audited companies may also incur indirect costs related to the requirements. For example, some commenters asserted that the 100-issuer threshold could deter triennially inspected firms from accepting new public company audit engagements or encourage firms to resign from existing audit engagements to avoid crossing the 100-issuer threshold. Although we recognize this possibility, for context regarding the number of firms currently around the 100-issuer threshold, staff analysis of audit reports included in SEC filings indicates that, during the 2022 calendar year, two NAFs audited between 80 and 100 issuers and two NAFs audited between 100 and 120 issuers. 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 requirements improve compliance with applicable professional and legal 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 QC 1000 results in changes to firms' client acceptance and continuance practices, firms may require greater fees or refuse to accept or retain high-risk clients. While this outcome would represent a cost to audited companies, the result could be a more efficient audit market if riskier companies pay more. These indirect costs will be reduced to the extent that firms will have already implemented the requirements in response to similar actions of other standard setters or due to other developments.

b. Costs of key provisions

i. Scaled applicability

Scaled-applicability firms will incur the design costs discussed above. Should a scaled-applicability firm ever become subject to the implementation and operation requirements, the firm will then incur the implementation and operation costs discussed above. As with other registered firms, the costs to scaled-applicability firms will be less to the extent they will already be complying with ISQM 1 or SQMS 1. Firms and a related group suggested allowing firms that do not perform engagements the flexibility to design their QC system in accordance with another QC standard, such as ISQM 1 or SQMS 1, to help manage costs. However, we expect the design costs for those firms to be limited to incremental requirements around ethics, independence, monitoring, and remediation. 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.

ii. In-process monitoring activities

We believe the in-process monitoring requirement may contribute to the direct and indirect costs discussed above such as: (1) developing documentation, (2) providing training, (3) gathering additional audit evidence, and (4) other potential indirect costs such as the time required of issuers to provide their auditor with additional or more extensive audit evidence. The costs will depend on the extent to which firms already have in-process monitoring activities in place. In addition, in-process monitoring may result in increased audit fees. Information gathered through PCAOB inspection activities indicates that 11 out of 14 annually inspected firms perform some in-process engagement monitoring activities.

iii. Firm governance structure

We believe there could be costs to design, implement, and operate the oversight function (i.e., EQCF). For example, firms that are required to incorporate the oversight function into their governance structure for the first time may incur costs when retaining appropriate individuals from outside of the firm.⁴⁹⁹ Firms with an existing oversight function may incur costs to find different individuals to fill the role. In addition, firms with an existing oversight function may incur incremental costs to incorporate the baseline requirement to evaluate, at a minimum, significant judgments made and the related conclusions reached by the firm when evaluating and reporting on the effectiveness of its QC system.

Several commenters expressed concern that the oversight function would be costly or difficult to fulfill, especially for firms that audit between 100 and 500 issuers. One commenter suggested the oversight function could add costs that ultimately have to be passed on through higher audit fees, which investors in smaller issuers are unlikely to support, particularly when the costs are spread over a small amount of invested public capital in a firm's issuer audits clients. Conversely, one commenter said that the costs of the oversight function could be reduced by engaging an independent accounting firm to provide weekly advisory services.

To help address these cost concerns, the requirement will allow firms to implement an oversight function into their QC system 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

⁴⁹⁹ According to Spencer Stuart, the average compensation per non-employee director was \$327,764 in 2023. See 2023 U.S. Spencer Stuart Board Index (2023), available at <https://www.spencerstuart.com/-/media/2021/october/ssbi2021/us-spencer-stuart-board-index-2021.pdf> (analyzing 489 DEF-14A proxy statements filed by S&P 500 companies with the SEC between May 1, 2022 and April 30, 2023). We note that variation between the responsibilities of an oversight function and a non-employee director function may limit the relevance of this cost reference to some extent.

indicate, as of the 2020 inspection cycle, that they already have a governance structure that includes a non-employee.

iv. The automated independence process

We believe there could be costs to design, implement, and operate the required automated process to identify investments in securities that might impair independence. The costs will depend on the extent to which firms already have such an automated process in place. Information gathered through PCAOB inspection activities indicates that nine out of 14 annually inspected firms already have one in place. The remaining five have processes in place that are not fully automated. Firms will be able to automate the process in a way that is suitable to their unique facts and circumstances. Most firms will likely need to: (1) convert their restricted entity list into a searchable electronic form; (2) maintain the electronic restricted entity list; and (3) develop queries that can compare a manager's or partner's relevant investments in securities to the electronic restricted entity list. Some firms may choose to integrate the automated process with existing systems related to client acceptance or time and expense. Firms with simple restricted entity lists (e.g., fewer clients, fewer subsidiaries) or simpler QC policies and procedures for restricted entities (e.g., any investment in any security of a restricted entity is restricted) may require less investment in software and expertise than other firms.

Several commenters said that the proposed automated process will entail significant costs. One commenter emphasized that there will be upfront and ongoing investments in technology and other overhead to operate such a process. Another commenter noted that implementing and maintaining an automated independence monitoring system is costly for smaller firms, which audit predominantly privately held companies and have not previously been subject to the automated independence system requirement under SEC rules. One commenter said it was unaware of any truly off-the-shelf system responsive to the proposed requirement. One commenter emphasized that for firms that audit between 100 and 500 issuers, the main potential downside of an automated process is the associated time and incremental cost to develop an efficient and effective system. The commenter noted that, in addition to software costs, there will be costs to oversee the system to ensure the data entered are correct and firm personnel are trained to use the system. Another commenter noted that the six largest firms represent 60% of issuers and approximately 98.7% of the capital markets and asserted that the automated independence process will nearly triple the number of firms required to implement automated investment tracking systems but pick up less than 15% of issuers, which represent less than 1% of the capital markets. The same commenter also asserted that the differences in size, scope, nature, and complexity between the six largest annually inspected firms and other annually inspected firms can be immense and that more than 80% of the commenter's issuer client count consists of either Form 11-K audits or audits of smaller companies, which have less impact on capital markets. While the commenter provided these figures in response to costs of the automated independence process, the same figures

could apply to the costs and benefits of each of the key policy provisions that invoke the 100-issuer threshold.

To help address these views, the final standard clarifies that the required automated process: (1) will apply only to the identification of relevant investments in securities and (2) will permit firms to rely on firm professionals accurately self-reporting and entering their investments into the system (e.g., direct brokerage feeds will not be expressly mandated). In addition, we believe that existing software products likely could be adapted to respond to the requirements. Furthermore, off-the-shelf systems more tailored to the requirements may enter the market in the future. Notwithstanding the commenters' views, we have retained the automated independence process requirement, and we acknowledge there will be costs to design, implement, and operate it.

v. Complaints and allegations policies and procedures

We expect the policies and procedures regarding complaints and allegations will entail direct costs to firms to design, implement, and maintain. Most notably, firms will incur additional variable costs to receive, investigate, and address complaints and allegations. Firms that issued audit reports with respect to more than 100 issuers during the prior calendar year will incur costs to implement confidentiality protections. The costs will depend on the extent to which firms already have policies and procedures regarding complaints and allegations in place. Information gathered through PCAOB inspection activities indicates that 10 out of 14 annually inspected firms already have hotlines in place that may satisfy certain of the complaints and allegations requirements.⁵⁰⁰

vi. Reporting the annual QC system evaluation

We expect the requirement to report the annual QC system evaluation to the PCAOB will entail an additional annual cost to firms to prepare Form QC. However, since firms will already be required to perform and document the evaluation, any additional costs associated with preparing Form QC should be minimal. The requirement may also result in some increased litigation risk to the extent that information reported to the PCAOB is not subject to privilege under Section 105(b)(5) of Sarbanes-Oxley, and to the extent that reporting of this information to a third party may vitiate other privileges that otherwise could have been used to protect the information from compelled disclosure in third-party actions. Non-protected material may become subject to compulsory production, which could impose indirect costs on firms to the extent that legal or other consequences may flow from that production.

⁵⁰⁰ According to one hotline vendor that posted their service prices online, the annual fee for a hotline that covers up to 75 employees starts at \$1,200 and the annual fee for a hotline that covers more than 5,000 employees starts at \$7,000 (see <https://www.allvoices.co/basic-purchase>). We note that the complaints and allegations provisions include more than having a hotline.

vii. Certification of the annual QC system evaluation

The certification requirement itself may not impose much direct cost on firms because the evaluation activities precede certification. 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 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, and the certifications may have an impact in third-party litigation. For example, the threat of liability for negligent conduct could lead to costs if individuals demand additional remuneration or take additional steps to act reasonably and demonstrate that they have acted reasonably (e.g., assuring themselves that the QC system is appropriately designed) or to defend against enforcement allegations. 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.

viii. Responding to engagement deficiencies identified after issuance of the audit report

The amendments to AS 2901, *Consideration of Omitted Procedures After the Report Date*, and related amendments to AT No. 1 and AT No. 2 will contribute to the engagement-level costs discussed above to the extent auditors will 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. We expect the requirement to extend the scope of AS 2901 to include the ICFR audit within its scope will be particularly impactful because the audit of internal control over financial reporting is both resource-intensive⁵⁰¹ and a common and recurring area of deficiency.⁵⁰²

ix. SECPS requirements

The requirements will refine, integrate into QC 1000, and extend to all firms the SECPS member requirements currently required under PCAOB Rule 3400T. We expect this will increase development, implementation, and operating costs for firms not already subject to

⁵⁰¹ 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).

⁵⁰² See, e.g., 2020 Inspection Observations Preview.

these requirements. 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.

3. Unintended consequences

The requirements could give rise to unintended consequences. Overall, however, we expect any potential unintended consequences will be mitigated by other factors.

a. Human capital

Some firms may require additional staff resources to implement the 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. One commenter reported the commenter's own analysis to demonstrate that audits are largely conducted by non-CPAs with limited experience in the field of auditing. QC 1000 includes quality objectives that mitigate these risks. For example, firms will be required to establish quality objectives that individuals who are assigned to 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.⁵⁰³

Some commenters argued that the costs of QC 1000 would be especially significant due to labor shortages. One commenter asserted that an aggressive enforcement atmosphere may create disincentives for individuals to join the profession, harming the talent pipeline that is necessary for the production of high-quality audits. Another commenter raised concerns that recruiting and retaining partners and employees for a firm's QC system will be a tremendous challenge for firms willing and able to absorb additional costs to properly implement the requirements of QC 1000 given the tight labor market. One commenter reported that some market research indicates significant declines in the number of new CPA candidates and annual accounting degree completions.⁵⁰⁴ The commenter also reported commentary from a survey that reveals the largest accounting firms regularly score low along dimensions that are most indicative of their desirability as places to work.⁵⁰⁵ Another commenter cited news articles⁵⁰⁶

⁵⁰³ See QC 1000.44c. and e.

⁵⁰⁴ See AICPA Trends Report.

⁵⁰⁵ See Mark Kolakowski, *Best Accounting Firms (Vault Top 50 Accounting Firms)* (Jan. 14, 2020).

⁵⁰⁶ See, e.g., Lindsay Ellis, *Why so Many Accountants are Quitting*, Wall St. J. (Dec. 28, 2022); Stephen Foley, *Accountants Work to Shed "Boring" Tag Amid Hiring Crisis*, Financial Times (Oct. 3, 2022).

and academic research⁵⁰⁷ that suggest attracting and retaining talent is a serious concern for accounting firms and university accounting programs. However, based on its preliminary survey research, another commenter reported that some QC leaders do not feel resource constrained.⁵⁰⁸

The Board acknowledges the commenters' concerns about the potential impact on staff resources. However, the potential impact on staff resources is likely the result of the interplay among numerous factors in the labor market, such as the rigor of qualifying for and completing the requirements for CPA licensure and the relatively low starting salaries being cited by college students as one of the main hurdles to choosing accounting as a major. To meet 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 wages and potentially higher audit fees, which could be exacerbated by the concentration of large firms in the audit market. Higher wages could in turn help firms attract and retain a skilled workforce or encourage qualified individuals to take essential roles at firms.⁵⁰⁹ The principles-based features and scalable nature of QC 1000 described above in Section III.C, as well as the 100-issuer threshold for some provisions, help mitigate this risk because fewer resources will be required for firms based on those features.

b. Competition

The requirements could also cause firms to exit the public company audit market or deter other firms from future entry. Entry deterrence could be exacerbated by the fact that being registered with the PCAOB will subject firms to certain QC requirements even if they do not perform engagements. Several commenters agreed that the proposed requirements, if adopted, could impact competition. One commenter expressed concern that the incremental requirements of QC 1000 relative to other QC standards could lead smaller high-quality firms to exit the market. One commenter asserted that the certification requirement would be an especially significant driver of exit, particularly for smaller firms. Some commenters suggested that the design requirement for scaled-applicability firms could lead some scaled-applicability firms to deregister with the PCAOB or create a barrier to entry. One commenter added that the design requirement for scaled-applicability firms could impact audit markets beyond the U.S. by creating a disincentive for foreign firms to serve specific audit markets. Another commenter

⁵⁰⁷ See, e.g., Hermanson, et al., *The Work Environment in Large Audit Firms* A38; Dana R. Hermanson, Heather M. Hermanson, Susan D. Hermanson, *Where is Public Company Auditing Headed?*, 90 *CPA Journal* 54 (2020); Westermann, et al., *PCAOB Inspections* 694.

⁵⁰⁸ See Hayne, et al., *Managing Quality Control*.

⁵⁰⁹ 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; AICPA Private Companies Practice Section, *2021 PCPS CPA Top Issues Survey*; AICPA, *2021 Trends: A Report on Accounting Education, the CPA Exam and Public Accounting Firms' Hiring of Recent Graduates* ("AICPA Trends Report") (Apr. 2022).

suggested that further enhancing the scalability of QC 1000 may be helpful for smaller firms to stay competitive. One commenter noted that QC 1000 requirements may serve as an impediment to audit firm mergers and acquisitions and otherwise perturb market activity. Correspondingly, less consolidation could mitigate concentration or help preserve a competitive dynamic amongst firms. Nevertheless, the presence of fewer firms could reduce competition in the public company audit market even in light of additional scalability or fewer mergers and acquisitions. Some commenters said that some firms may resign existing issuer clients or decline new ones to avoid incremental QC 1000 requirements for firms that issue more than 100 audit reports. This could lead to a further reduction in competition for engagements that these firms would otherwise compete. This reduction in competition would likely only apply to actual or potential issuer clients of firms that are close to the 100-issuer threshold. As noted in Section VI.C.2.a, staff analysis of audit reports included in SEC filings indicates that, during the 2022 calendar year, the number of firms currently around the 100-issuer threshold includes two NAFs that audited between 80 and 100 issuers and two NAFs that audited between 100 and 120 issuers.

Confirming the widely held view that audit firms compete on price, some research suggests that reduced competition is indeed associated with higher audit fees.⁵¹⁰ However, any exit would likely be limited primarily to firms with small market shares and to the smaller issuer or broker-dealer audit markets, which research suggests tend to be competitive.⁵¹¹ For example, firms that would manage their client portfolio to avoid incremental QC 1000

⁵¹⁰ 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*, 38 *Journal of Accounting and Public Policy* 1 (2019).

⁵¹¹ While research generally has focused on competition for the largest public company audits and the corresponding concentration amongst the largest audit firms, less is known about market forces within the smaller audit firm market. However, some research has studied competitive aspects of the smaller firm market. See, e.g., Tracy Ti Gu, Dan A. Simunic, Michael T. Stein, Minlei Ye, and Ping Zhang, *The Market for Audit Services: The Role of Market Power*, 19 *Journal of International Accounting Research* 3 (2020) (concluding that small public companies can potentially purchase audit services from any audit firm and that the number of suppliers to small public companies is relatively higher than the number of suppliers to large public companies); Kenneth L. Bills and Nathaniel M. Stephens, *Spatial Competition at the Intersection of the Large and Small Audit Firm Markets*, 35 *Auditing: A Journal of Practice and Theory* 23 (2016) (concluding that smaller and larger firms compete locally in some cases); Andrew Kitto, Phillip T. Lamoreaux, and Devin Williams, *Do Entry Barriers Allow Low Quality Audit Firms to Enter the Public Company Audit Market?*, available on SSRN: <https://ssrn.com/abstract=3572688>(2023) (concluding that current barriers to entry likely deter some audit firms from entering the audit market but that current barriers fail to prevent entry by firms that are significantly lower quality compared to incumbent firms); Brant Christensen, Kecia Williams Smith, Dechun Wang, and Devin Williams, *The Audit Quality Effects of Small Audit Firm Mergers in the United States*, 42 *Auditing: A Journal of Practice & Theory* 75 (2023) (concluding that audit quality decreases post-merger based on data regarding mergers of very small audit firms).

requirements would likely prefer to resign (or decline to accept) smaller issuer clients than larger issuer clients. Moreover, some research suggests that reduced competition may have a positive impact on audit quality because it curtails issuers' opportunity to opinion shop.⁵¹² Compounding this effect, the requirements may further deter opinion shopping as a basis for competition to the extent they would improve auditors' compliance with professional standards. One commenter argued that opinion shopping is not prevalent and any reduction in opinion shopping would be minimal.

c. Network resources

Some commenters expressed concern that the requirements could diminish the availability of global network resources and that smaller firms around the world could decline to assist U.S. firms in their global audits. One commenter added that this could be detrimental to overall engagement quality. Several factors could mitigate this potential unintended consequence. First, staff analysis of 2021 Form AP filings finds that 74% of all audits (32% of Fortune 500 audits) do not use other auditors.⁵¹³ Second, this potential unintended consequence would likely be limited primarily to firms that lack the network resources to implement QC 1000. One academic study finds that 94% of component auditors identified on Form AP are affiliated with the principal auditor (99% when the principal auditor is a GNF).⁵¹⁴ Third, other auditors that do not play a substantial role on any PCAOB engagement would be able to deregister with the PCAOB and continue to perform their existing roles on the engagements. Fourth, the competitiveness of the smaller issuer audit market suggests that principal auditors would be able to retain a different component auditor of comparable quality. Finally, to the extent the requirements would lead a firm to retain a lower-quality component auditor, existing PCAOB standards related to audits involving other auditors could help mitigate the risk that the new component auditor performs a low-quality component audit.⁵¹⁵ It is possible that, despite the requirements, firms may not 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 firm's risk assessment process and monitoring and remediation process

⁵¹² See, e.g., Nathan J. Newton, Julie S. Persellin, Dechun Wang, and Michael S. Wilkins, *Internal Control Opinion Shopping and Audit Market Competition*, 91 *The Accounting Review* 603 (2016); 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*, 32 *Auditing: A Journal of Practice & Theory* 31 (2013).

⁵¹³ See PCAOB Rel. No. 2022-002, at Figure 2.

⁵¹⁴ See William M. Docimo, Joshua L. Gunn, Chan Li, and Paul N. Nichas, *Do Foreign Component Auditors Harm Financial Reporting Quality? A Subsidiary-Level Analysis of Foreign Component Auditor Use*, 38 *Contemporary Accounting Research* 3113 (2021).

⁵¹⁵ See, e.g., PCAOB Rel. No. 2022-002.

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 QC 1000 centralizes responsibility for QC to a degree, other requirements could mitigate this risk. For example, individual responsibility features prominently in QC 1000 and PCAOB auditing standards emphasize the responsibility of the engagement partner for the engagement and its performance.⁵¹⁶

d. Accountability

Some commenters expressed concern that the accountability provisions of QC 1000 could have potentially harmful unintended consequences. For example, one commenter asserted that good faith actions with regard to supervisory responsibilities could become subject to PCAOB enforcement. Some commenters suggested that the roles and responsibilities requirements could reduce audit quality or increase costs by creating a disincentive for the most qualified individuals to take on the specified roles. One commenter noted that individual certification poses a potential threat of additional liability and could affect the recruitment of talented individuals needed to fill critical roles within firms. Another commenter noted that for firms with an issuer practice that makes up a small portion of the overall practice, it can be difficult to find partners to fill lead and engagement quality reviewer roles on engagements when those roles are subject to a higher risk of individual enforcement actions.

We acknowledge that, in addition to positive consequences, accountability can have negative consequences, such as disincentives from taking on QC roles with greater accountability. One commenter suggested that the incorporation of rewards into the firms' accountability model could mitigate this potential unintended consequence. QC 1000 contemplates that the firm's compensation plans and performance evaluations will appropriately incentivize firm personnel to fulfill their assigned responsibilities⁵¹⁷ and that firm leadership will be held accountable for quality, including through their performance evaluations and compensation.⁵¹⁸ Depending on the firm's specific quality risks, including the risk that qualified individuals may be unwilling to take on QC roles, firms can incorporate both positive incentives ("carrots") and negative incentives ("sticks") in the design of their incentive plans.

⁵¹⁶ See, e.g., QC 1000.42a.(1); AS 1201.03. The Board has also proposed to clarify the engagement partner's existing responsibilities for supervision and review in AS 1201, AS 1215, and AS 2101 to provide more specificity about the engagement partner's responsibility to exercise due professional care related to supervisory and review activities required to be performed under existing auditor requirements. See PCAOB Rel. No. 2023-001 at 15.

⁵¹⁷ See QC 1000.44g.

⁵¹⁸ See QC 1000.25b.

e. Scalability

One commenter expressed concern based on academic research that limiting the applicability of certain requirements to firms of a certain size could give rise to audit quality differences between larger and smaller firms. In general, the incremental requirements for larger PCAOB audit practices are less suitable to smaller PCAOB audit practices' QC systems. For example, a smaller firm may not need an automated system to track investments if it has a stable number of issuer clients and a small group of persons subject to independence requirements. But if a smaller firm does not achieve its quality objectives or the reasonable assurance objective, it will have to take remedial action, which could include implementing some or all of the incremental QC system features that are expressly required for larger PCAOB audit practices.

f. Design requirements under scaled applicability

Some commenters expressed concern that scaled-applicability firms could design QC systems inappropriate for the future circumstances that would arise should the firm eventually become a full-applicability firm. One commenter cited research that suggests audit firm personnel designing a QC system to address hypothetical future circumstances will need to overcome numerous cognitive biases.⁵¹⁹ We believe this potential unintended consequence is mitigated by QC 1000's proactive approach. For example, the firm will be required to 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. When such changes are identified, the firm will be required to determine what, if any, modifications are needed to make them on a timely basis. In effect, a scaled-applicability firm's QC system design should be appropriate for its circumstances in the event it becomes a full-applicability firm.

⁵¹⁹ See, e.g., Paul J.H. Schoemaker, *Forecasting and Scenario Planning: The Challenges of Uncertainty and Complexity*, in *Blackwell Handbook of Judgment & Decision Making*, eds. D.J. Koehler and N. Harvey, 274 (2004); Edward J. Joyce and Gary C. Biddle, *Anchoring and Adjustment in Probabilistic Inference in Auditing*, 19 *Journal of Accounting Research* 120 (1981); Noel Harding and Ken T. Trotman, *Improving Assessments of Another Auditor's Competence*, 28 *Auditing: A Journal of Practice & Theory* 53 (2009); Byron J. Pike, Mary B. Curtis, and Lawrence Chui, *How Does an Initial Expectation Bias Influence Auditors' Application and Performance of Analytical Procedures?*, 88 *The Accounting Review* 1413 (2013); Amos Tversky and Daniel Kahneman, *Judgment under Uncertainty: Heuristics and Biases*, 185 *Science* 1124 (1974); Steven M. Glover, James Jambalvo, and Jane Kennedy, *Analytical Procedures and Audit-Planning Decisions*, 19 *Auditing: A Journal of Practice & Theory* 27 (2000); Vicky B. Hoffman and Mark F. Zimbelman, *Do Strategic Reasoning and Brainstorming Help Auditors Change their Standard Audit Procedures in Response to Fraud Risk?*, 84 *The Accounting Review* 811 (2009); Tim D. Bauer, Sean M. Hillison, Mark E. Peecher, and Bradley Pomeroy, *Revising Audit Plans to Address Fraud Risk: A Case of "Do as I Advise, Not as I Do"?*, 37 *Contemporary Accounting Research* 2558 (2020).

g. Other potential unintended consequences

Because firms' QC systems will likely operate over all of their engagements, including those that are not subject to PCAOB standards, the engagement-level costs discussed in Section VI.C.2.a above could apply to those engagements as well. Moreover, one commenter asserted that firms with a significant private company client base will be challenged by different documentation retention policies based on client base since many aspects of QC relate to the firm as a whole. Correspondingly, the requirements could improve compliance on those engagements because they would be governed by more effective QC policies and procedures. Indeed, one commenter said that requiring all firms to design a QC system that complies with QC 1000 could have a beneficial impact on private company audits.

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.⁵²⁰ The principles-based features and scalable nature of QC 1000 described above in Section III.C, as well as the 100-issuer threshold for some provisions, help mitigate these concerns by providing firms the ability to design, implement, and operate policies and procedures to support achievement of the reasonable assurance objective based on their facts and circumstances.

D. Alternatives Considered

During the development of the 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 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

⁵²⁰ See, e.g., John Seddon, *Ten Arguments Against ISO 9000*, 7 *Managing Service Quality: An International Journal* 162 (1997); Bozena Poksinska, Jörgen AE Eklund, and Jens Jörn Dahlgaard, *ISO 9001:2000 in Small Organisations Lost Opportunities, Benefits and Influencing Factors*, 23 *International Journal of Quality & Reliability Management* 490 (2006).

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 decades 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

QC 1000 shares the same basic structure as ISQM 1 and SQMS 1. We also considered basing QC 1000 on a different quality management framework, such as COSO or ISO 9001, or developing our own risk-based approach. The essential features of these other quality management frameworks are broadly similar to ISQM 1 and SQMS 1. For example, they 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 QC 1000 on a different 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 QC 1000 on a different quality management framework or an original PCAOB risk-based approach would likely be more costly. As highlighted in Section VI.A.5 above, we expect that many firms are familiar with ISQM 1 or SQMS 1 and have made, or will make, investments in 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 QC 1000 on a different quality management framework or an original PCAOB risk-based

approach therefore would likely require 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 QC 1000 on a different quality management framework or an original PCAOB risk-based approach may introduce an element of regulatory complexity, which could both increase cost and detract from audit quality for firms that would be required to comply with ISQM 1 or SQMS 1.⁵²¹

3. Key policy choices

In this section, we discuss several potential provisions that we have decided against including in QC 1000. These provisions relate to: (1) applicability; (2) the threshold for incremental requirements; (3) firm governance structure; (4) self-assessment monitoring; (5) in-process monitoring activities; (6) the evaluation and reporting dates; (7) reporting the annual QC system evaluation; (8) certification of the annual evaluation; (9) public reporting; and (10) audit committee communications.

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 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 requirements 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 approach by withdrawing from PCAOB registration. Furthermore, any reduced costs would not address the risk that firms could be unprepared to accept and perform engagements in compliance with applicable professional and legal requirements.

Section III.C.1 above also discusses commenters' views on alternative approaches to this key policy choice. For example, several commenters suggested allowing scaled applicability firms to design a QC system that complies with ISQM 1. One commenter suggested limiting the

⁵²¹ One commenter suggested that the Board look at any lessons learned or studies published by the IAASB or the AICPA related to their quality management standards to help inform any refinements that might be needed or additional implementation guidance that might be useful for adoption of QC 1000. As discussed in Section II and Section III above, we have taken into consideration actions by other standard setters and requirements of their quality management standards in the development of QC 1000. We searched for studies but did not find any available. We note that the recent effective date of ISQM 1 on December 15, 2022, and the forthcoming effective date of SQMS 1 on December 15, 2025, may explain a dearth of lessons learned or post-implementation studies published by IAASB or the AICPA to date.

design requirements to acceptance and continuance policies. One commenter suggested limiting the design requirement to firms that satisfy an issuer client market capitalization criterion. While these alternative approaches could reduce some of the costs to scaled-applicability firms associated with designing their QC systems, they could also reduce the benefit of firms having a PCAOB-compliant QC system ready for implementation and operation. Furthermore, as discussed above, firms could avoid the costs of designing a QC system that complies with QC 1000 by deregistering.

b. Threshold for incremental requirements

Section III.C.2 above discusses the incremental requirements that will apply only to firms that issued audit reports for more than 100 issuers in the prior calendar year (e.g., requirements related to firm governance structure). Several commenters suggested alternative thresholds. For example, some commenters suggested the threshold should consider the market capitalizations of issuer clients. One commenter suggested that the threshold should consider the types of financial statements being audited.⁵²² These alternative approaches could help ensure QC 1000 is appropriately scalable to the facts and circumstances of all firms. However, we believe there could be practical challenges with implementing a more complex threshold. For example, market capitalization can be volatile and would require PCAOB and firm resources to track. Some firms may cross an issuer market capitalization threshold multiple times within a short period of time. Issuer count, by contrast, aligns with Rule 4003, *Frequency of Inspections*, is easier to track, and may not be as volatile as market capitalization. Finally, while market capitalization may be a useful proxy for investor exposure to the issuers audited by the firm, it would be a less useful proxy for the complexity of a firm's QC system.

c. Firm governance structure

Section IV.E.1.b above discusses specified quality responses related to governance and leadership. We considered extending to all firms the requirement to incorporate into their governance structure an external oversight function for the QC system composed of one or more persons who are not principals or employees of the firm and do not otherwise have a commercial, familial, or other relationship with the firm that would interfere with the exercise of independent judgment regarding matters related to the QC system. However, in light of the direct cost of such an oversight function, which could disproportionately impact smaller PCAOB audit practices, and reflecting our view that the public interest in such independent oversight is strongest in relation to the largest firms, the requirement applies only to firms that issued audit reports with respect to more than 100 issuers during the prior calendar year.

⁵²² The commenter noted that a large percentage of their issuer audit counts consist of Form 11-K audits, which have limited impact on the capital markets.

Some commenters suggested that more than one independent member of the oversight function should be required. In support of this view, one commenter noted that the independent member(s) would be in the minority and cited academic research regarding audit committees that suggests oversight functions are more effective with a greater proportion of independent members.⁵²³ Another commenter referred to a report that cites survey research that suggests female directors improve corporate governance and that the positive influence is most significant when there are three or more female directors.⁵²⁴ The same commenter suggested that the oversight function should have public reporting responsibilities. Some commenters suggested that the independent oversight member should have more control. We acknowledge the commenters' views on the potential additional benefits of additional independent oversight requirements. However, we are also sensitive to the costs of any additional requirements, which several commenters suggested may be costly or difficult to fulfill.⁵²⁵

d. Self-assessment monitoring

We considered permitting 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 work in accordance with applicable professional and legal requirements and the firm's policies and procedures.⁵²⁶ 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

⁵²³ See, e.g., F. Todd DeZoort, Dana R. Hermanson, Deborah S. Archambeault, and Scott A. Reed, *Audit Committee Effectiveness: A Synthesis of the Empirical Audit Committee Literature*, 21 *Journal of Accounting Literature* 38 (2002); Jean Bédard and Yves Gendron, *Strengthening the Financial Reporting System: Can Audit Committees Deliver?*, 14 *International Journal of Auditing* 174 (2010); Joseph V. Carcello, Dana R. Hermanson, and Zhongxia (Shelly) Ye, *Corporate Governance Research in Accounting and Auditing: Insights, Practice Implications, and Future Research Directions*, 30 *Auditing: A Journal of Practice & Theory* 1 (2011).

⁵²⁴ See The Conference Board, *Maximizing the Benefits of Board Diversity: Lessons Learned from Activist Investing* at 13 (June 2020); Alison M. Konrad, Vicki W. Kramer, and Sumru Erkut, *Critical Mass: The Impact of Three or More Women on Corporate Boards*, 37 *Organizational Dynamics* 145 (2008).

⁵²⁵ See Section VI.C.2.b.iii.

⁵²⁶ See QC 1000.44e.

circumstances, the firm may use other participants or third-party providers to perform monitoring activities.

e. In-process monitoring activities

Section IV.K.1.c.ii above discusses in-process monitoring activities. We considered extending the requirement to monitor in-process engagements to all firms but 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 are generally subject to quality risks for which in-process monitoring is an appropriate quality response. We also understand through our oversight activities that the majority of smaller PCAOB audit practices do not perform in-process monitoring activities and may lack the resources to do so. Therefore, to balance these concerns, QC 1000 includes a "should consider" requirement to provide sufficient scalability for firms that issue audit reports with respect to 100 or fewer issuers.

f. Evaluation and reporting dates

Several commenters suggested that QC 1000 should allow firms to choose their own evaluation date. This alternative could reduce the cost of QC 1000 by allowing firms to perform the evaluation when most convenient. For example, some firms could set their QC 1000 evaluation date near their ISQM 1 evaluation date and use parts of their ISQM 1 evaluation for their QC 1000 evaluation. However, the information reported to the PCAOB on Form QC would be less current and therefore less informative to the PCAOB when it selects firms and engagements for inspection, inspection focus areas, and inspection procedures. Tracking firms' compliance with the evaluation requirements could also be more challenging. In addition, the inherent differences between the QC 1000 and ISQM 1 evaluations will require incremental effort from firms to comply with QC 1000.

We initially proposed a November 30 evaluation date followed by 46 days from the evaluation date to both report and document the QC system evaluation. This timeline would provide the PCAOB with timely information to inform PCAOB oversight activities. Some commenters expressed concern that a November 30 evaluation date could present costs and other challenges because some firms have already chosen an alternative evaluation date under ISQM 1 or because the timeframe for the evaluation could conflict with some firms' inspection cycles or business cycles and can encompass holidays and religious observances. We are persuaded that a November 30 evaluation date could have led to unnecessary incremental resource demands during the busy and holiday seasons. Accordingly, we are instead requiring firms to adopt a September 30 evaluation date as discussed in Section IV.L.1.a. Some commenters expressed concern that 46 days would be insufficient to report on and document their evaluation. We are persuaded that 46 days to report on and document the QC system evaluation could have created unnecessary costs to firms. Therefore, under the final standard, a

firm will have 61 days to evaluate their QC system and an additional 14 days after the evaluation to assemble their documentation.

g. Reporting the annual QC system evaluation

Section IV.L.1.c above discusses firm reporting on the QC system evaluation. One commenter asserted that an explicit reporting requirement is unnecessary because the PCAOB inspection process provides the Board and staff with any relevant contemporaneous quality control information for both annual and triennially inspected firms. 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 would be less timely, structured, and consistent and likely would not inform our inspection approach as effectively, especially for triennial firms. It could 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. In addition, 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 QC 1000, that could diminish the discoverability of such information in litigation, thereby decreasing third-party litigation risk. However, this alternative approach would not address the lost information value, particularly for the triennial 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 reduce the value of Form QC to the PCAOB. For example, reporting on unremediated QC deficiencies would inform various aspects of our oversight activities, 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 could also diminish the beneficial incentive effect of mandatory reporting to the PCAOB.

Several commenters suggested that the PCAOB clarify that Form QC is submitted under the PCAOB's inspections authority, as a way of bestowing the confidentiality protections of Section 105(b)(5) upon the information provided therein. This would, according to commenters, alleviate uncertainty about the extent to which information submitted thereon may be subject to discovery or other disclosures, diminish a risk of unwarranted legal exposure, and help place the information in the context of the ongoing inspections dialogue. We acknowledge the commenters' concerns about these issues. However, as discussed in Section IV.L.1.c. above, QC 1000 is not an inspections rule; it is a QC standard that places obligations on all registered firms regardless of their inspection status (annual, triennial, or exempt), and as such we are not able to say that Form QC information is necessarily submitted "in connection with an

inspection” as would be necessary to trigger the confidentiality protections of Section 105(b)(5) of Sarbanes-Oxley.

h. Certification of the annual evaluation

Some commenters requested that the Board specify a heightened legal standard (e.g., recklessness) at which liability could be imposed on individuals for making a certification that is later determined to be false, or create safe harbors for inevitable system errors or the wrongful acts of others. As discussed above in Section IV.L.1.c, the standard for liability turns on the particular language of each statement in the certification: some statements are subject to a negligence standard, while others (namely those with knowledge qualifiers) give rise to liability only if the certifier knew that the statement was false or recklessly did not know it was false. We acknowledge that alternative approaches urged by commenters could have saved some costs. Specifically, limiting liability to recklessness in all circumstances would provide individuals with comfort that their decisions would not be second-guessed in litigation. This result may make the performance of those services more efficient by removing an incentive to perform tasks that are not directly related to quality. For example, individuals may be less incentivized to engage in self-protective behaviors if a heightened legal standard (e.g., recklessness) is imposed. In addition, more staff may be willing to take these roles (or to take them at a lower price) if liability or workload would have been more limited by a heightened legal standard.⁵²⁷ However, that approach would have attenuated the benefits sought to be achieved by the certification requirement by removing the Board’s ability to hold individuals accountable for conduct that fails to meet a reasonable person standard of care.

i. Public reporting

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. Some commenters suggested that the non-confidential portions of Form QC could be made publicly available. Such public reporting could in principle provide investors with additional information on audit quality and thereby help address the problem discussed in Section VI.B. However, we believe that significant portions of Form QC may be confidential. As a result, the non-confidential portions of Form QC could have been misleading and difficult to compare across firms. Public reporting of non-confidential portions of Form QC could also lead firms to be less candid in their Form QC reporting and thereby diminish its value to the PCAOB. Some commenters also expressed concern that any public reporting could be contrary to Sarbanes-

⁵²⁷ See Section IV.C.1.b for a discussion of commenters’ concerns regarding increased liability or workload associated with the roles as potential disincentives that may keep qualified individuals from accepting the roles.

Oxley. After considering the benefits and costs of alternative approaches, including those identified by commenters, we believe that firm reporting on Form QC should be nonpublic.

Several commenters suggested that QC 1000 should require firms to publicly disclose information related to audit quality. As discussed above, the Board is proposing separate rules related to firm and engagement metrics as well as firm reporting.⁵²⁸

j. Audit committee communications

Section IV.L.1.c.v above discusses commenters' views on potential required reporting to audit committees. We initially proposed to require the firm to discuss with the audit committee the conclusion of the firm's most recent annual evaluation of its QC system and a brief overview of remedial actions taken and to be taken. This information could give audit committees greater insight into the quality of their auditor. Several commenters were supportive of the proposed requirement. However, several other commenters asserted that the information could be largely difficult to understand, irrelevant to an individual audit committee, and potentially inconsistent with Sarbanes-Oxley. Furthermore, one commenter noted research and expressed concern that disclosure regarding the annual QC system evaluation to the audit committee only could enable audit committees to shop for lower-quality auditors.⁵²⁹ Similarly, another commenter expressed concern with an approach that would provide mandatory disclosure to audit committees but not to investors and the public. As discussed in Section IV.L.1.c.v above, we have determined not to adopt the proposed amendments to AS 1301 after consideration of the comments received.

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."⁵³⁰ As a result of the JOBS

⁵²⁸ See PCAOB Rel. No. 2024-002 and PCAOB Rel. No. 2024-003.

⁵²⁹ See, e.g., Melissa Carlisle, Wei Yu, and Bryan K. Church, *The Effect of Small Audit Firms' Failure to Remediate the PCAOB's Quality Control Criticisms on Audit Market Segmentation*, 41 *Journal of Accounting and Public Policy* 1 (2022).

⁵³⁰ 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

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,⁵³¹ PCAOB staff prepares a white paper annually that provides general information about characteristics of EGCs.⁵³² As of the November 15, 2022 measurement date, there were 3,031 companies⁵³³ that self-identified as EGCs and filed audited financial statements with the SEC between May 16, 2021, and November 15, 2022, that included an audit report signed by a firm. Of the 263 registered firms that audited EGCs, 227 firms (or 86%) performed audits for both EGC and non-EGC issuers.⁵³⁴ Approximately 98% of EGCs were audited by these 227 firms.⁵³⁵

PCAOB staff also gathered information on Part I.A deficiencies for the audits of EGCs between 2013 and 2022. Figure 6 presents 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.

statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an EGC. None of the rules and amendments would fall within either of these two categories.

⁵³¹ We are providing this analysis of the impact on EGCs to assist the SEC in making the determination required under Section 104 to the extent that the requirements apply to “the audit of any emerging growth company” within the meaning of Section 104 of the JOBS Act.

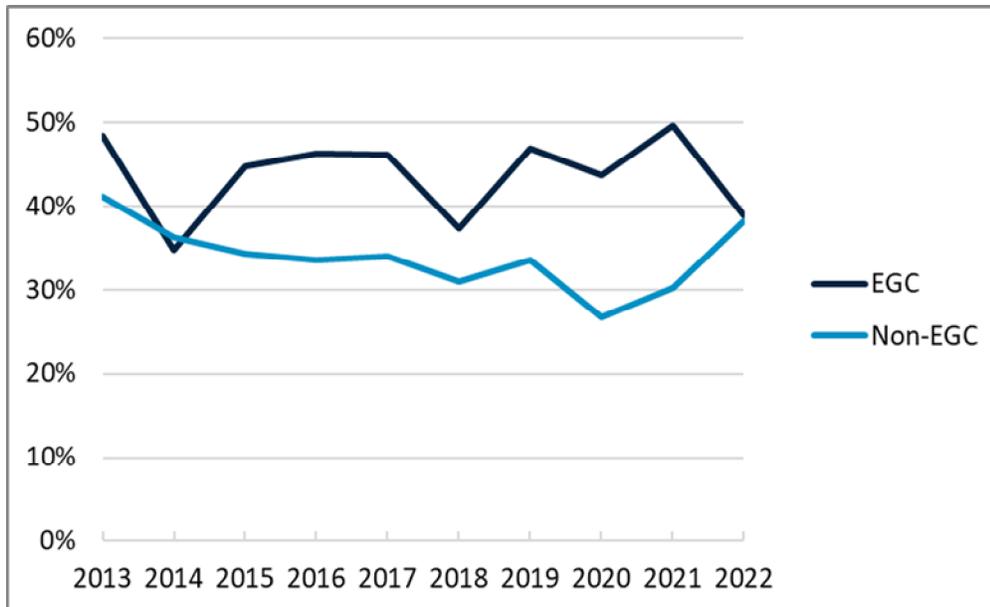
⁵³² See PCAOB, *Characteristics of Emerging Growth Companies and Their Audit Firms at November 15, 2022* (Feb. 20, 2024) (“EGC White Paper”), available at https://assets.pcaobus.org/pcaob-dev/docs/default-source/economicandriskanalysis/projectsother/documents/white-paper-on-characteristics-of-emerging-growth-companies-as-of-nov-15-2022.pdf?sfvrsn=a8294f3_2.

⁵³³ The EGC White Paper uses a lagging 18-month window to identify companies as EGCs. Please refer to the “Current Methodology” section in the EGC White Paper for details. Using an 18-month window enables staff to analyze the characteristics of a fuller population in the EGC White Paper but may tend to result in a larger number of EGCs being included for purposes of the present EGC analysis than would alternative methodologies. For example, an estimate using a lagging 12-month window would exclude some EGCs that are delinquent in making periodic filings. An estimate as of the measurement date would exclude EGCs that have terminated their registration or that have exceeded the eligibility or time limits.

⁵³⁴ See EGC White Paper, at 17.

⁵³⁵ See *id.*

Figure 6. Percentage of Inspected EGC and Non-EGC Issuer Audits Having at Least One Part I.A Deficiency (2013-2022)



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 QC system components for EGC and non-EGC audits and separate methodologies with respect to, for example, auditor obligations with respect to deficiencies in completed engagements and foundational ethics requirements, 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 methodology and QC system differentiation costs would affect at least the 227 registered firms that audit both EGCs and non-EGCs and that, collectively, audit approximately 98% of EGCs.

The discussion of economic impacts of the requirements is generally applicable to the audits of EGCs. In particular, the benefits to financial reporting quality articulated in Section VI.C.1.c above may be especially pertinent for EGCs, including improved efficiency of capital

allocation, lower cost of capital, and enhanced capital formation. EGCs tend to be smaller⁵³⁶ 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.⁵³⁷ 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 requirements could impact competition in an EGC product market if the indirect costs to audited companies of the requirements 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 requirements in the form of higher audit fees.

The proposal sought comment on the applicability of the proposed requirements to audits of EGCs. Some commenters agreed that the proposed requirements should apply to the audits of EGCs.

Accordingly, and for the reasons explained above, the Board will request that the Commission determine that it 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, to apply QC 1000 and the related amendments to Board standards, rules, and forms to audits of EGCs.

VIII. EFFECTIVE DATE

In the proposing release, the Board sought comment on the amount of time auditors would need before the proposed new quality control standard and the other proposed amendments to PCAOB standards, rules, and forms, if adopted by the Board and approved by

⁵³⁶ See EGC White Paper, at Figure 9 and Figure 12 (indicating that exchange-listed EGCs have lower market capitalization and revenue than exchange-listed non-EGCs).

⁵³⁷ For example, smaller public companies tend to have less analyst coverage and a greater share of insider holdings. See, e.g., Raymond Chiang and P. C. Venkatesh, *Insider Holdings and Perceptions of Information Asymmetry: A Note*, 43 *Journal of Finance* 1041 (1988); Ravi Bhushan, *Firm Characteristics and Analyst Following*, 11 *Journal of Accounting and Economics* 255 (1989).

the SEC, become effective. We proposed an effective date of December 15 of the year after approval by the SEC.

One commenter agreed that the proposed effective date should be reasonable in practical terms. Another commenter asserted that the standard is not clear on the effective date as it relates to design and implementation and operating effectiveness, and recommended that the Board allow firms significant time between the release of the final standard and its effective date. One commenter suggested that an 11-month period from the effective date to the first evaluation date would not be practicable, and firms would need time to consider whether and how to transition from their evaluation date previously established under ISQM 1.

Several commenters suggested that if the standard is approved in 2023, and becomes effective on December 15, 2024, this would provide challenges to auditors. Some of these commenters further suggested that the proposed effective date would be particularly challenging for smaller firms that might not have already implemented ISQM 1 and do not have to implement SQMS 1 until December 15, 2025. Commenters suggested alternative effective dates such as December 15, 2025; 18 months after approval by the SEC and no sooner than December 15, 2025; the later of 12 months after approval by the SEC or December 15, 2025; or two years after SEC approval. One commenter suggested a phased approach such that the effective date would be different for firms that are annually inspected than for other firms, while other commenters suggested that firms that are required to implement incremental requirements based on the size of the firm should be provided additional time to implement the incremental requirements. One commenter suggested that an overly speedy adoption timeline could create unintended consequences such as disruption to QC systems and increased difficulty of getting buy-in on the proposed QC changes from stakeholders. Another commenter suggested that an additional one to two years may be needed for firms with less than 100 issuers, or that have not adopted ISQM 1, to develop and implement the additional monitoring, evaluation and remediation requirements. The commenter further suggested that a proposed initial evaluation date that is eleven and a half months after the effective date may not allow enough time for remediation and that the PCAOB should consider a longer onboarding process.

After considering the comments received subject to approval by the SEC, the final standard and related amendments to auditing standards, rules, and forms will take effect on December 15, 2025.

We believe that an effective date of December 15, 2025 strikes an appropriate balance between the benefits to investors of having QC 1000 take effect as promptly as practicable, while allowing sufficient time for firms to design and implement robust, QC 1000-compliant QC systems.

One commenter suggested the Board consider how mergers and acquisitions of firms would impact the effective date for the standard, and suggested the Board consider similar

guidance to the SEC that provides that issuers may exclude an acquired business's internal control over financial reporting from its assessment of internal control for up to one year or for one assessment. After consideration of the comment received, we appreciate that it could take time to fully integrate a newly acquired firm's QC system and perform an evaluation of its effectiveness. However, we do not believe that it is appropriate or consistent with our investor protection mandate to allow for a portion of a firm's QC system to be excluded from the annual evaluation. We believe that specific quality risks could arise as the result of a merger or acquisition, and that firms should be designing, implementing, and operating quality responses to address these as part of merger planning and execution. Furthermore, if, as a result of a merger or acquisition between registered public accounting firms, the resultant firm is unable to conclude that the QC system is effective as of the evaluation date, then we believe that it is essential that the firm has identified and is remediating the QC deficiencies that exist as a result of the merger or acquisition and is monitoring any impact on the firm's engagements.

Unlike ISQM 1 and SQMS 1, under QC 1000, the requirements for QC system evaluation are not being implemented on a delayed basis. When QC 1000 takes effect, all provisions of QC 1000 will take effect. Because our evaluation date of September 30 builds in over a nine-month delay between the effective date of the standard and the first evaluation date, we do not believe further delaying the effective date of the evaluation requirements would be necessary or appropriate. However, the first evaluation period will be of the period beginning on the effective date of the standard (i.e., December 15, 2025) and ending on the next September 30, rather than the 12-month period ending on that September 30.

* * *

On the 13th day of May, in the year 2024, 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

May 13, 2024

APPENDIX 1—QUALITY CONTROL STANDARD (QC 1000)

QC 1000, A Firm's System of Quality Control

Introduction

.01 A quality control (“QC”) system of a registered public accounting firm (“firm”), 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*¹ and the issuance of informative, accurate, and independent *engagement reports*² 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 through the preparation of informative, accurate, and independent *engagement reports*.

.02 This standard sets forth the requirements for a firm with respect to the design, implementation, and operation of a 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 and compliance with *applicable professional and legal requirements*. 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.

.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 *engagements*;
- e. *Engagement* performance;

¹ Terms defined in Appendix A, *Definitions*, are italicized throughout the standard.

² “Engagement reports” refers to reports issued in connection with *engagements* (e.g., audit, attest, examination, or review).

- 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 .10-.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 A properly conducted *engagement* and the related report enhance the confidence of investors and other market participants in the company’s information to which the firm’s report relates. The objective of the firm is to design and, if applicable, implement and operate an effective QC system. An effective QC system protects investors by facilitating the consistent preparation and issuance of informative, accurate, and independent *engagement* reports in accordance with *applicable professional and legal requirements*. To accomplish this, an effective QC system consistently provides a firm with reasonable assurance that:

- a. The firm, each member of *firm personnel*, and each *other participant*:
 - (1) Conduct each of the firm’s *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. Each *engagement* report issued by the firm is in accordance with *applicable professional and legal requirements*

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

Note: Reasonable assurance is not absolute assurance, but a high level of assurance. It 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.

.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 .10-.17);
- b. Establish *quality objectives*, annually identify and assess *quality risks* to the achievement of those objectives, and design *quality responses* to address 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*,³ and thereafter through the following September 30.⁴
- 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).⁵
- c. A firm that is required to implement and operate its QC system is also required to annually evaluate its QC system as of September 30 and report on that evaluation (*see* paragraphs .77-.80).

³ 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 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report*; AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*.

⁴ *See* paragraph .77 (requiring evaluation of the effectiveness of the QC system as of September 30).

⁵ *See* PCAOB Rule 1001(p)(ii).

- 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.

- .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 unregistered accounting firms.

Roles and Responsibilities

.10 All *firm personnel* and *other participants* involved in the design, implementation, and operation of the QC system must exercise due professional care in all matters related to the QC system. Due professional care concerns what those individuals do and how well they do it. Due professional care means acting with reasonable care and diligence, exercising professional skepticism, acting with integrity, and complying with *applicable professional and legal requirements*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the relevant information.

.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 needed to enable them to carry out their assigned responsibilities.⁶ 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: Each of the roles identified in subparagraphs a.-c. above cannot be shared, but rather must be assigned to only one individual. However, 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.

⁶ See Note in paragraph .44a. of this standard for a description of competence.

.13 The firm should establish a direct line of communication from each individual assigned operational responsibilities (see paragraph .12) 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:

- 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 a 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 address 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 *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 extent to which a culture of integrity and a commitment to audit quality, including ethics and independence, is promoted within the firm and embraced by *firm personnel* across all levels;
 - (e) The resources of the firm;
 - (f) The environment in which the firm operates, including *applicable professional and legal requirements*;

- (g) 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;
- (h) If the firm uses *other participants*, the nature and extent of their involvement;
- (i) If the firm participates in other firms' *engagements*, the nature and extent of the firm's participation; and
- (j) 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 This 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 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*;⁷
 - (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*,

⁷ See paragraph .46.

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, including through their performance evaluation and compensation.
- 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*.
- 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*.⁸

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)⁹ or equivalent—within the QC system.

⁸ See paragraphs .44h. and .44i. for an explanation of technological and intellectual resources.

⁹ See paragraph .11.

.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 external oversight function for the QC system composed of one or more persons who are not partners, shareholders, members, other principals, or employees of the firm and do 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 (an “External QC Function” or “EQCF”). The EQCF should have the experience, competence, authority, and time necessary to enable them to carry out the responsibilities assigned to the EQCF by the firm. The responsibilities of the EQCF should include, at a minimum, evaluating the significant judgments made and the related conclusions reached by the firm when evaluating and reporting on the effectiveness of its QC system.

.29 The firm should design, implement, and maintain policies and procedures for addressing 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, and other participants*. Such policies and procedures should be made available to all *firm personnel and other participants* and address:

- a. Processes and responsibilities for receiving complaints and allegations from internal and external parties (for example, policies and procedures regarding a complaints mailbox or hotline or a whistleblower program);
- b. Protecting persons making complaints and allegations from retaliation;
- c. Investigating and addressing complaints and allegations; and

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

- d. If the firm issued audit reports with respect to more than 100 issuers during the prior calendar year, providing a confidential and anonymous process for submitting complaints and allegations and protecting the confidentiality of the individuals and entities that made a complaint or allegation during the investigation.

Ethics and Independence

.30 This component addresses the fulfillment of firm and individual responsibilities under ethics and independence requirements.¹⁰

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.¹¹
- 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 risk* being addressed, specified *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

¹⁰ Ethics and independence requirements include PCAOB independence and ethics standards and rules, the U.S. Securities and Exchange Commission (“SEC”) rule on auditor independence, and other applicable requirements regarding accountant ethics and independence that are relevant to fulfilling their obligations and responsibilities in the conduct of *engagements* or in relation to the QC system, 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*.

¹¹ 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*.

- .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;¹²
 - 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 companies for which the firm performs *engagements*, other *firm personnel*, and regulators);¹³
 - c. Obligations of associated persons of the firm,¹⁴ 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, *firm personnel*, affiliates of the firm, 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, and activities that could constitute ethics or independence violations involving the firm, *firm personnel*, and, with

¹² 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*.

¹³ See PCAOB Rule 3500T, *Interim Ethics and Independence Standards*; EI 1000, *Integrity and Objectivity*.

¹⁴ 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 others performing work on behalf of the firm who are subject to such requirements 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).¹⁵

.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, the process to identify investments in securities that might impair the independence of the firm or such *firm personnel* must 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 the process to identify investments in securities that might impair the independence of the firm or such *firm personnel*, 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, for example, financial relationships, employment relationships, business relationships, non-audit services, contingent fee arrangements, partner rotation, certain tax services, and arrangements requiring audit committee pre-approval.¹⁶

¹⁵ The term “audit committee” has the same meaning as it does in AS 1301, *Communications with Audit Committees*.

¹⁶ See, e.g., Regulation S-X Rule 2-01(c), 17 C.F.R. § 210.2-01(c); PCAOB Rules 3522 and 3523.

The term “restricted entities” includes all audit clients (including affiliates of the audit client) of the firm and affiliates of the firm.¹⁷

- 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, at least monthly (and more frequently, if appropriate), additions to the list of restricted entities to *firm personnel* and others performing work on behalf of the firm whose relationships and arrangements with such additional restricted entities may reasonably be thought to bear on the independence of the firm.

- 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 additions to the list of restricted entities are communicated by the firm, (3) prior to themselves or a relevant family member¹⁸ 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 role¹⁹), and (5) prior to entering into any business or employment relationships, and,

¹⁷ “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).

¹⁸ 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).

¹⁹ *See* Regulation S-X Rule 2-01(f)(11), 17 C.F.R. § 210.2-01(f)(11) (defining “covered persons in the firm”).

- 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;
- e. Obtaining certifications from *firm personnel* regarding familiarity and compliance with (1) SEC and PCAOB independence requirements, applicable ethics requirements, and the firm’s independence and ethics policies and procedures upon employment and at least annually thereafter, and (2) SEC and PCAOB independence requirements and the firm’s independence policies and procedures upon any change in professional circumstances that is relevant to independence; and
 - f. Identifying matters that require audit committee pre-approval and obtaining such pre-approval.²⁰

.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 Engagements

.37 This component addresses the firm’s processes for making decisions about whether to accept or continue an *engagement*.

Acceptance and Continuance of Engagements Quality Objectives

.38 The *quality objectives* established by the firm with respect to the acceptance and continuance of *engagements* should include the following:

- a. Judgments about whether to accept or continue an *engagement* are:

²⁰ 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*.

- (1) Initially made as part of or before performing preliminary *engagement* activities;²¹
 - (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;²²
 - (c) The extent to which the firm is or will be able to gain access to company information to perform the *engagement*, including to company personnel who provide such information;
 - (d) The extent to which the firm has or can obtain resources to perform the *engagement*;²³ 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 company (including management and the audit committee).²⁴
- 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 company.²⁵

²¹ See, e.g., paragraph .06 of AS 2101, *Audit Planning*.

²² 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.

²³ See, for example, paragraph .06H of AS 2101, 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*.

²⁴ 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*.

²⁵ See, e.g., AS 1301.05.

Acceptance and Continuance of Engagements Specified Quality Response

.39 In designing and implementing *quality responses* to address the *quality risks* in the acceptance and continuance of *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 *quality responses* may need to be combined with other *quality responses* designed and implemented by the firm.

.40 The firm should design, implement, and maintain policies and procedures to address situations in which the firm becomes aware of information subsequent to accepting or continuing an *engagement* that could have caused the firm to decline such *engagement* had that information been known prior to acceptance or continuance.²⁶

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:²⁷

- (1) The responsibilities of the engagement partner for an *engagement* and its performance;²⁸

²⁶ For purposes of this standard, the firm is deemed “aware” of information when any partner, shareholder, member, or other principal of the firm first becomes aware of such information.

²⁷ 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.

²⁸ For purposes of this standard, the “practitioner with final responsibility” in AT Section 101, *Attest Engagements*, is treated as the “engagement partner.”

- (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*;²⁹ 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 or addressed as a difference in professional judgment in accordance with paragraph .42c;
 - (2) In accordance with *applicable professional and legal requirements*; and
 - (3) Implemented before the issuance of the *engagement report*.³⁰
- 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*.³¹

²⁹ See generally, e.g., AS 1201, *Supervision of the Audit Engagement*.

³⁰ 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.

³¹ 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.

- d. *Engagement* documentation is prepared, reviewed, assembled, and retained in accordance with *applicable professional and legal requirements*.³²

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.³³

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. Competence is measured both qualitatively and quantitatively.

- 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. *Firm personnel* and individuals who are *other participants* assigned to *engagements*, including the engagement partner and engagement quality reviewer, have the competence, objectivity, and time needed to fulfill their responsibilities on such *engagements* in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures.

³² See generally AS 1215.

³³ For certain specified activities and responsibilities of certain *firm personnel*, see paragraphs .10-.17.

- 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. *Firm personnel* and individuals who are *other participants* assigned to perform activities within the QC system have the competence, objectivity, authority, and time needed to perform such activities in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures.³⁴
- 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, including through compensation plans and decisions in which quality considerations play a critical part, and (3) held accountable for their actions and failures to act.³⁵
- 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, to enable the operation of the firm’s QC system and the performance of its *engagements*, including, for example, the

³⁴ These individuals include engagement quality reviewers and those performing activities within the QC system, such as monitoring activities.

³⁵ Paragraph .46 describes appropriate standards of conduct by *firm personnel*.

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*:³⁶
 - (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, other *firm personnel* participating in an *engagement* to obtain and maintain the competence to fulfill their respective assigned *engagement* roles, including an understanding of the following:

³⁶ 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*.

- 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*;
- d. For attestation *engagements*, the subject matter of the assertion on which the *engagement* is based;
- e. The industry in which the company operates and its relevant characteristics (e.g., applicable standards, industry-specific risks, and industry-specific estimates);
- f. The internal control framework used by the company;
- g. The use of technology by the company 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.³⁷

- e. If a firm communicates firm-level or *engagement*-level information with respect to the firm’s audit practice, *firm personnel*, or *engagements*, such as firm or *engagement* metrics, to external parties, such information is accurate and not misleading and, with respect to any such metrics that are communicated in writing,

³⁷ 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.

- the communication explains in reasonable detail how the metrics were determined and, if applicable, how the method of determining them changed since the 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*.
- g. If *other participants* are used in the firm’s QC system or *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 the aspects of the QC system and the *engagements* in which they are involved can be performed in accordance with *applicable professional and legal requirements*.³⁸

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 system³⁹ of the *other participant* firm.

- 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.

³⁸ See, e.g., AS 1201.08-.13.

³⁹ 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 “evaluation date” (as defined in paragraph .77), 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 evaluation date, then this provision refers to the most recent QC evaluation performed by the *other participant* firm under any professional standard.

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.

.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* to the extent and 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 a 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 timely detection of *engagement deficiencies* and *QC deficiencies*; and
 - c. Remediate identified *engagement deficiencies* and *QC deficiencies* and take any other required actions in relation to such deficiencies in accordance with *applicable professional and legal requirements* 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 observations* 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

Note: For firms that issued *engagement* reports with respect to five or fewer *engagements* for issuers, brokers, and dealers during the prior calendar year, *engagement* monitoring activities may include monitoring audits not performed under PCAOB auditing standards, provided that such audits are selected taking into account the factors in paragraph .64 and that instances of noncompliance with applicable auditing standards identified through monitoring are treated as if they were “*engagement deficiencies*” for purposes of paragraph .68d and “*QC observations*” for purposes of paragraph .72. Audits not performed under PCAOB

auditing standards cannot be included in the monitoring required under paragraph .62b.

- 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.

Note: In accordance with paragraph .44e, it is a *quality objective* that individuals performing monitoring activities have, among other things, the objectivity needed to perform such activities in accordance with *applicable professional and legal requirements* and the firm’s policies and procedures. Generally, individuals cannot perform monitoring activities over their own work.

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 incorporate a level of unpredictability in their selection and monitoring of completed *engagements*, such that an engagement partner would not be certain of at least one of: (i) which *engagement* would be selected, (ii) which areas within the *engagement* would be selected, or (iii) when an *engagement* would be selected. While some firms may be permitted to perform *engagement* monitoring activities on audits not performed under PCAOB auditing standards (see Note to paragraph .61a), inspections under this subparagraph b must be of *engagements*.

.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 *engagements*, 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. *Quality responses*, including their timing, frequency, scope, and operation;
- c. The nature, timing, extent, and results of previous monitoring activities undertaken by the firm and, if applicable, a network, including from inspections of completed *engagements*, monitoring 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 a 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 *engagement* monitoring activities.

- 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 company 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 *quality risks*, 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,⁴⁰ 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. *Quality responses*, including their timing, frequency, scope, and operation;
- c. For monitoring activities over the firm’s risk assessment process and monitoring and remediation process, the design of those processes (including any metrics the firm may use in 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 a 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.

⁴⁰ 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 a Network

.66 In circumstances when a 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, on a timely basis, evaluate the following information and 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 a 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 or other complaints regarding either a company or the firm; 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(s)* are 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*,⁴¹ unless it is probable that the *engagement report(s)* are not being relied upon;⁴²

Note: In the absence of circumstances indicating that reliance is impossible or unreasonable (e.g., cessation of a trading market for issuer securities), inclusion of an *engagement report* (either directly or through incorporation by reference) in the most recent filing on an SEC form that requires inclusion of such an *engagement report* evidences that the report is being relied upon.

- c. For *engagement deficiencies* relating to work performed on other firms' *engagements*, communicate the *engagement deficiency* to the other firm and take such 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*;

⁴¹ See paragraph .70.

⁴² The term "probable" has the same meaning as used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

and if so, take actions described in paragraphs .68a.-c. above, as applicable.

.69 The firm should take action pursuant to paragraph .68, taking into account the nature and severity of the *engagement deficiency*.

Note: As appropriate, actions a firm may take include preventive or corrective actions, or a combination, such as actions: (1) on in-process *engagements* to address *engagement deficiencies* before the issuance of the *engagement* report; (2) to address *engagement deficiencies* on completed *engagements*; and (3) 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 2901, *Responding to Engagement Deficiencies After Issuance of the Auditor’s Report*; 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*; and paragraphs 21.-24. of AT No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, as applicable.

Determining Whether QC Observations Exist

.71 The firm must, on a timely basis, evaluate the following information and determine whether *QC observations* exist:

- a. Information from *engagement* monitoring activities and QC system-level monitoring activities (including, if applicable, those performed by a 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, on a timely basis, evaluate *QC observations* and determine 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 observation*, which includes:
 - (1) The component(s) of the QC system, *quality objective(s)*, or *quality risk(s)* to which the *QC observation* relates;

- (2) Whether the *QC observation* is in the design, implementation, or operation of the QC system;
 - (3) The frequency with which the *QC observation* occurred; and
 - (4) The duration of time that the *QC observation* existed; and
- b. The likelihood that the matter(s) that gave rise to the *QC observation* 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.⁴³

Evaluation of 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 September 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 whether either of the presumptions described in paragraph .78a. arises and, when relevant, the factors listed in paragraph .78b.

- a. A *major QC deficiency* would be presumed to exist if there is an unremediated *QC deficiency* or combination of unremediated *QC deficiencies* that:
 - (1) Relates to the firm’s governance and leadership that affect the overall environment supporting the operation of the QC system; or
 - (2) Results in or is likely to result in one or more significant engagement deficiencies⁴⁴ in *engagements* that, taken together, are significant in relation to

⁴³ See paragraphs .64 and .65 when determining the nature, timing, and extent of monitoring activities for remedial actions.

⁴⁴ A significant engagement deficiency exists when (1) the engagement team failed 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).

Note: A firm may rebut the presumption that a *major QC deficiency* exists only if the firm demonstrates, taking into account both factors listed in paragraph .78b. (including all of the listed examples in paragraph .78b.(1)), that the unremediated *QC deficiency* or combination of unremediated *QC deficiencies* does not constitute a *major QC deficiency*.

- b. The following factors are relevant (i) in rebutting a presumption under paragraph .78a., and (ii) for unremediated *QC deficiencies* that do not give rise to a presumption under paragraph .78a., in determining whether a *major QC deficiency* exists:
- (1) The severity and pervasiveness of the unremediated *QC deficiency* or combination of unremediated *QC deficiencies*, which may be evidenced by, for example:
 - (a) The number of components or *quality objectives* directly or indirectly affected;
 - (b) The extent to which the unremediated *QC deficiency* or combination of unremediated *QC deficiencies* relate to a component, *quality objective*, or *quality response* that affects the design or operation of other aspects of the QC system;
 - (c) The number and pervasiveness of root causes;
 - (d) The persistence of the unremediated *QC deficiency* or combination of unremediated *QC deficiencies* over time;
 - (e) The number of *engagements* that are affected by the unremediated *QC deficiency* or combination of unremediated *QC deficiencies* or are likely to be affected in the future if the *QC deficiencies* are not remediated;

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.

- (f) The number of *engagements* that may have unsupported opinions unless additional procedures are performed; and
- (g) 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* or combination of unremediated *QC deficiencies*, the firm would consider both quantitative and qualitative implications.

- (2) 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 November 30.

.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 paragraph .80a.(2) or paragraph .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, as required by paragraph .27.
- 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 a 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;⁴⁵

⁴⁵ See AS 1215.16 for documentation requirements regarding actions taken to address *engagement deficiencies* on completed audit *engagements*.

- (4) The evaluation of *QC observations* to determine whether *QC deficiencies* exist and the basis for each determination;⁴⁶ 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.⁴⁷
- 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 the design, implementation, and operation of the QC system, 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.

Note: With respect to the operation of the QC system, the documentation must include documentation that enables an experienced auditor to evaluate the operation of the *quality responses*.

⁴⁶ See paragraph .72.

⁴⁷ See paragraphs .73-.76.

.84 A complete and final set of documentation as required by paragraphs .81-.83 with respect to the 12-month⁴⁸ period ended the prior September 30 and any evaluation required as of that date should be assembled for retention not later than December 14 (“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 the documentation of its QC system required under paragraphs .81-.83 and paragraph .85 for seven years from the QC documentation completion date, unless a longer period of time is required by law.

⁴⁸ In the first year that the firm is required to evaluate its QC system under paragraph .77, the period is from the date on which the firm becomes subject to such requirement to the next September 30.

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 in the conduct of *engagements* or in relation to the QC system, rules of the SEC, other provisions of U.S. federal securities law, ethics laws and regulations, and other applicable statutory, regulatory, and other legal requirements.
- .A3 Engagement – Any audit, attestation, review, or other engagement performed under PCAOB standards:
- (1) Led by a firm; or
 - (2) 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. Professional staff does not include persons engaged only in clerical or ministerial tasks.

.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*.

.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 unregistered), 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 observation* that, based on the evaluation under paragraph .72, individually, or in combination with one or more other *QC observations*, evidences:

- (1) That the likelihood of the firm not achieving the reasonable assurance objective or one or more *quality objectives* has not been reduced to an acceptably low level;

Note: The likelihood of not achieving the reasonable assurance objective or one or more *quality objectives* would be above an acceptably low level 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 observation –

- (1) An engagement deficiency; or
- (2) Any other observation about the design, implementation, or operation of the firm’s QC system that may indicate one or more QC deficiencies exist.

.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*.
- (2) Procedures are actions to implement and comply with policies.

.A12 Quality risks – Risks (whether or not related to intentional acts by *firm personnel* or *other participants* to deceive or to violate *applicable professional and legal requirements*) that, individually or in combination with other risks, have a reasonable possibility of occurring and, if they were to occur, a reasonable possibility of adversely affecting the firm’s achievement of one or more *quality objectives*.

.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 and firm ownership (e.g., reorganizations, mergers and acquisitions, divestitures, or extent of non-CPA ownership);
- 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 (e.g., revenue generation or business development) compared to the quality of the firm's engagements.

.B5 The extent to which a culture of integrity and a commitment to audit quality, including ethics and independence, is promoted within the firm and embraced by *firm personnel* across all levels (20a.(1)(d)). This includes how a commitment to quality is embedded in the firm's culture and exists throughout the firm. Examples include:

- a. Recognizing the firm's fundamental obligation to protect investors through the preparation and issuance of informative, accurate, and independent auditor's reports;
- b. Emphasizing the importance of professional ethics, values and attitudes;
- c. Emphasizing the responsibility of all *firm personnel* for quality relating to the performance of engagements or activities within the QC system, and their expected behavior;
- d. Establishing and adhering to a code of conduct;

- e. Defining and communicating how quality will be measured and incorporating quality-related measures in personnel evaluations, with associated effects on compensation and promotion;
- f. Establishing developmental opportunities for personnel that reinforce quality; and
- g. Defining the purpose and values of the firm, and ensuring that these recognize quality.

.B6 The resources of the firm (.20a.(1)(e)). 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 companies for which the firm performs *engagements* and the risks associated with such technological resources, including their susceptibility to cybersecurity breaches; and
- f. Nature of technology development and resources to maintain the technology (e.g., internally developed versus purchased).

.B7 The environment in which the firm operates, including *applicable professional and legal requirements* (.20a.(1)(f)). 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*.

.B8 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)(g)). 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.

.B9 If the firm uses *other participants*, the nature and extent of their involvement (.20a.(1)(h)). 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.

.B10 If the firm participates in other firms’ *engagements*, the nature and extent of the firm’s participation (.20a.(1)(i)). 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.

.B11 If the firm uses resources or services obtained from *third-party providers*, the nature and extent of those resources or services (.20a.(1)(j)). 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, if any, 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.

.B12 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 (e.g., the laws and regulations to which the companies are subject), 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 the company 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 –REPORTING RULE AND FORM QC

The Board is adopting a new Rule 2203A and new Form QC. The text of this rule and form is set forth below.

Rule 2203A. Report on the Evaluation of the Firm’s System of Quality Control

(a) 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.

(b) 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 November 30 following the relevant “evaluation date” (as defined in QC 1000.77).

(c) 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.

(d) 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 November 30. 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. Period Covered by this Report. The reporting period, which the Firm should enter in Item 2.1, is the period beginning on October 1 of the year preceding the year in which Form QC is required to be filed (or, if a firm's obligation to implement and operate a QC system arises under QC 1000.07a. after October 1 of that year, the date on which that obligation arises), and ending September 30 of the year Form QC is required to be filed.
5. 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.”

6. 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.
7. 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 and Reporting Period

- a. State the evaluation date of this report; and
- b. State the reporting period covered by 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 engagements
 6. Engagement performance
 7. Resources
 8. Information and communication
 9. Monitoring and remediation process
 10. Evaluation of 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 QC 1000.78, but the determination was made that there is no *major QC deficiency*, furnish, as Exhibit 2.5, a narrative describing the firm's determination pursuant to the Note to paragraph .78a.

**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 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 September 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 September 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 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 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 –AMENDMENTS TO AS 2901

AS 2901 is retitled and amended in its entirety to read as follows:

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 deficiency¹ is identified² on an audit of financial statements or internal control over financial reporting, unless it is probable³ that the auditor’s report is not being relied upon.

Note 1: In the absence of circumstances indicating that reliance is impossible or unreasonable (e.g., cessation of a trading market for issuer securities), inclusion of an auditor’s report (either directly or through incorporation by reference) in the most recent filing on an SEC form that requires inclusion of such an auditor’s report evidences that the report is being relied upon.

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:

- a. The auditor should perform procedures to obtain additional evidence, to the extent necessary, such that the opinion is supported by sufficient appropriate evidence; or
- b. If the auditor is not able to obtain sufficient appropriate evidence to support the opinion, the auditor should 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*.

.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: As appropriate, actions a firm may take include preventive or corrective actions, or a combination, such as actions: (1) to address engagement deficiencies on completed engagements; and (2) 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.

¹ “Engagement deficiency” is defined in QC 1000, *A Firm’s System of Quality Control*, Appendix A—*Definitions*.

² See paragraph .67 of QC 1000 on determining when an engagement deficiency exists.

³ The term “probable” has the same meaning as used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

APPENDIX 4 – EI 1000; RELATED AMENDMENTS; RESCISSION OF ET SECTION 102

The Board is rescinding ET Section 102 and adopting new standard EI 1000 and amendments to: (i) Rule 3500T; (ii) ET Section 101; and (iii) ET Section 191.

EI 1000, Integrity and Objectivity

.01 In connection with their responsibilities under applicable professional and legal requirements¹ 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 company employees and boards of directors, 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) when having the authority to do so, failing to correct a document that is materially false or misleading when made (including when filed with or submitted to a regulatory authority), or when otherwise subject to a duty to correct the document.
- 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,² 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.

¹ The term “applicable professional and legal requirements” is used as defined in paragraph .A2 of QC 1000, *A Firm’s System of Quality Control*.

² The term “audit committee” is used as defined in paragraph .A2 of AS 1301, *Communications with Audit Committees*.

Rule 3500T. Interim Ethics and Independence Standards.

Rule 3500T paragraph (a) is amended to read as follows:

(a) A registered public accounting firm and its associated persons shall comply with ethics standards, as described in EI 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 as in existence on April 16, 2003 (AICPA Professional Standards, ET §191 (AICPA 2002)).

ET Section 101 – Independence

ET Section 101 paragraph .04 is amended to read as follows:

.04

* * *

Considering Employment or Association With the Client

* * *

The appropriate person should consider what additional procedures may be necessary to provide reasonable assurance that any work performed for the client by that person was performed with objectivity and integrity as required under EI 1000, *Integrity and Objectivity*. Additional procedures, such as reperformance of work already done, will depend on the nature of the engagement and the individual involved.

* * *

ET Section 101 paragraph .13 is amended to read as follows:

.13

* * *

In circumstances where the individual or entity that engages the firm is not the responsible party or associated with the responsible party, individuals on the attest engagement team need not be independent of the individual or entity, but should consider their responsibilities under EI 1000, *Integrity and Objectivity*, with regard to any relationships that may exist with the individual or entity that engages them to perform these services.

* * *

ET Section 101 paragraph .16 is amended to read as follows:

.16

* * *

Other Matters

* * *

3. When making referrals of services between Newfirm and any of the entities within PublicCo, a member should consider the provisions of EI 1000, *Integrity and Objectivity*.

* * *

ET Section 191 – Ethics Rulings on Independence, Integrity, and Objectivity

ET Section 191 paragraph 31. is amended to remove the last sentence of paragraph .062.

* * *

ET Section 191 paragraphs 65., 85., 93., 99., and 101. are amended to read as follows:

[65.] Use of the CPA Designation by Member Not in Public Practice

[Paragraphs .130-.131 deleted.]

* * *

[85.] Bank Director

[Paragraphs .170-.171 deleted.]

* * *

[93.] Service on Board of Directors of Federated Fund-Raising Organization

[Paragraphs .186-.187 deleted.]

* * *

[99.] Member Providing Services for Company Executives

[Paragraphs .198-.199 deleted.]

* * *

[101.] Client Advocacy and Expert Witness Services

[Paragraphs .202-.203 deleted.]

* * *

APPENDIX 5 – OTHER AMENDMENTS

In connection with the adoption of QC 1000, *A Firm's System of Quality Control* ("QC 1000"), the Board is adopting related amendments to several of its rules, standards, and forms. We are also adopting other technical and clarifying amendments.

QC 1000 supersedes the Board's interim quality control standards in their entirety. Rule 3400T, *Interim Quality Control Standards*, is rescinded. Upon rescission of Rule 3400T, the interim quality control standards referenced in it, listed below along with the applicable appendices, will 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 replaced with Rule 3400, which describes the auditor’s responsibilities for complying with quality control standards adopted by the Board and approved by the SEC.

PCAOB Rule, Standard, or Form	Paragraph(s)	Subject Heading of Paragraph(s) Affected	Action	Page
Rule 2204. <i>Signatures</i>	All	All	Amend	A5-8
Rule 2205. <i>Amendments</i>	All	All	Amend	A5-8
Rule 2206. <i>Date of Filing</i>	(c)	N/A	Add	A5-8
Rule 3400T. <i>Interim Quality Control Standards.</i>	All	All	Rescind	A5-8
Rule 3400. <i>Quality Control Standards</i>	N/A	N/A	Add	A5-9
AS 1110, <i>Relationship of Auditing Standards to Quality Control Standards</i>	All	All	Rescind	A5-9
AS 1215, <i>Audit Documentation</i>	.09	Audit Documentation Requirement	Make conforming amendment	A5-9
AS 1215	.11	Documentation of Specific Matters	Make conforming amendment	A5-9
AS 1220, <i>Engagement Quality Review</i>	.04	Qualifications of an Engagement Quality Reviewer	Amend	A5-10
AS 1220	.05	Competence	Amend footnote 3	A5-10
AS 1220	.10a	Engagement Quality Review for an Audit	Make conforming amendment	A5-10

PCAOB Rule, Standard, or Form	Paragraph(s)	Subject Heading of Paragraph(s) Affected	Action	Page
		Engagement Quality Review Process		
AS 1220	.15a	Engagement Quality Review for a Review of Interim Financial Information Engagement Quality Review Process	Make conforming amendment	A5-10
<i>AS 1310, Notification of Termination of the Auditor-Issuer Relationship</i>	N/A	N/A	Add	A5-11
<i>AS 2101, Audit Planning</i>	.06a	Preliminary Engagement Activities	Make conforming amendment to footnote 3	A5-12
AS 2101	.07	Planning Activities	Make conforming amendment	A5-12
<i>AS 2110, Identifying and Assessing Risks of Material Misstatement</i>	.05c	Performing Risk Assessment Procedures	Make conforming amendment	A5-12

PCAOB Rule, Standard, or Form	Paragraph(s)	Subject Heading of Paragraph(s) Affected	Action	Page
AS 2110	.41	Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements	Make conforming amendment	A5-13
<i>AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</i>	.09	Planning the Audit	Make conforming amendment	A5-13
AS 2201	.99	Subsequent Events	Add	A5-14
<i>AS 2315, Audit Sampling</i>	.11	Uncertainty and Audit Sampling	Make conforming amendment	A5-14
<i>AS 4105, Reviews of Interim Financial Information</i>	.08	Applicability	Make conforming amendment to footnote 6	A5-14
<i>Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers</i>	39., 40., 41., 42.	Responding to Engagement Deficiencies After the	Add	A5-15

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>	21., 22., 23., 24.	Responding to Engagement Deficiencies After the Issuance of a Review Report	Add	A5-16
<i>AT Section 101, Attest Engagements</i>	.16, .17, .18	The Relationship of Attestation Standards to Quality Control Standards	Amend	A5-17
AT Section 101	.46	Standards of Fieldwork Planning and Supervision	Make conforming amendment to footnote 10	A5-17
AT Section 101	.103	Attest Documentation	Make conforming amendment to footnote 23	A5-18
ET Section 101 – Independence	.01	Rule 101 – Independence	Make conforming amendment	A5-18

PCAOB Rule, Standard, or Form	Paragraph(s)	Subject Heading of Paragraph(s) Affected	Action	Page
Form 1 – Application for Registration	1., 3.	General Instructions	Amend	A5-18
Form 1	4.2	Part IV - Statement of Applicant’s Quality Control Policies	Add	A5-19
Form 2 – Annual Report Form	3.1A	Part III - General Information Concerning the Firm	Add	A5-19
Instructions to Form AP – Auditor Reporting of Certain Audit Participants	Part IV	Responsibility for the Audit is Not Divided	Amend	A5-20

Note: The amended paragraphs referenced above include revisions to the accompanying footnotes.

Rule 2204. Signatures

Rule 2204 is amended to read as follows:

Each signatory to a report on Form 2, 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

Rule 2205 is amended to read as follows:

Amendments to a filed report on Form 2, Form 3, or Form QC shall be made by filing an amended report on the applicable form in accordance with the instructions to that form 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

Rule 2206 is amended by adding paragraph (c) to read as follows:

(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.

Rule 3400T is rescinded

Rule 3400. Quality Control Standards.

Rule 3400 is added to read as follows:

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.

AS 1110, Relationship of Auditing Standards to Quality Control Standards

AS 1110 is rescinded

AS 1215, Audit Documentation

AS 1215 is amended by revising paragraph .09 to read as follows:

.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 1215 is amended by revising paragraph .11 to read as follows:

.11 Certain matters, such as auditor independence, staff competence, training and acceptance and continuance of engagements, 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

AS 1220 is amended by revising the Note to paragraph .04 to read as follows:

.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 1000.10, 33b.-c., and .44a. and c.

AS 1220 is amended by revising footnote 3 to read as follows:

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.³

³ See also QC 1000.44c., .46, and .48 on competence to perform engagements and fulfill assigned roles.

AS 1220 is amended by revising paragraph .10 to read as follows:

.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 acceptance and continuance of engagements evaluation,

* * *

AS 1220 is amended by revising paragraph .15 to read as follows:

.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 acceptance and continuance of engagements evaluation,

AS 1310, Notification of Termination of the Auditor-Issuer Relationship

AS 1310 is added to read as follows:

Objective

.01 The objective of the auditor is to ensure that the issuer and the SEC are notified when the relationship between an auditor and an issuer it has audited has ended.¹

¹ This standard uses the term “issuer” as defined in PCAOB Rule 1001(i)(iii).

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 regarding a significant subsidiary, 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-issuer 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-issuer 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

AS 2101 is amended by revising paragraph .06a and footnote 3 to read as follows:

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 engagement,³

³ See paragraph .38 of QC 1000, *A Firm's System of Quality Control*.

* * *

AS 2101 is amended by revising paragraph .07 to read as follows:

.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 acceptance and continuance of engagements evaluation; and

* * *

AS 2110, Identifying and Assessing Risks of Material Misstatement

AS 2110 is amended by revising paragraph .05c to read as follows:

.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 acceptance and continuance of engagements evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs .41-.45);

* * *

AS 2110 is amended by revising paragraph .41 to read as follows:

Considering Information from the Acceptance and Continuance of Engagements Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

.41 *Acceptance and Continuance of Engagements and Audit Planning Activities.* The auditor should evaluate whether information obtained from the acceptance and continuance of engagements 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

AS 2201 is amended by revising paragraph .09 to read as follows:

.09 The auditor should properly plan the audit of internal control over financial reporting and properly supervise the engagement team^{7A} 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 acceptance and continuance of engagements evaluation; and

* * *

AS 2201 is amended by adding paragraph .99 and footnote 20 to read as follows:

.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.²⁰ 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*, unless it is probable that the audit report is not being relied upon.

Note: In the absence of circumstances indicating that reliance is impossible or unreasonable (e.g., cessation of a trading market for issuer securities), inclusion of a report on internal control over financial reporting (either directly or through incorporation by reference) in an issuer’s most recent filing on an SEC form that requires inclusion of such an audit report evidences that the report is being relied upon.

²⁰ “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

AS 2315 is amended by revising paragraph .11 to read as follows:

.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.

AS 4105, Reviews of Interim Financial Information

AS 4105 is amended by revising footnote 6 in paragraph .08 to read as follows:

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).⁶ 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.

⁶ See paragraph .38b. of QC 1000, *A Firm's System of Quality Control*.

Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers

AT 1 is amended by adding paragraphs 39-42 to read as follows:

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.²⁰ When the auditor has determined that an engagement deficiency exists, the auditor should take action to address the deficiency unless it is probable²¹ that the examination report is not being relied upon.

Note: The auditor must treat as relied upon any examination report that is included (either directly or through incorporation by reference) 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:

- a. The auditor should perform procedures to obtain additional evidence, to the extent necessary, such that the opinion is supported by appropriate evidence that is sufficient; or
- b. If the auditor is not able to obtain sufficient appropriate evidence to support its opinion, the auditor should 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: As appropriate, actions a firm may take include preventive or corrective actions, or a combination, such as actions: (1) to address engagement deficiencies on completed engagements; and (2) 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.

²⁰ “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.

²¹ 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

AT 2 is amended by adding paragraphs 21-24 to read as follows:

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.¹⁴ When the auditor has determined that an engagement deficiency exists, the auditor should take action to address the deficiency unless it is probable¹⁵ that the review report is not being relied upon.

Note: The auditor must treat as relied upon any review report that is included (either directly or through incorporation by reference) 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 support the auditor’s conclusion:
- a. The auditor should perform procedures to obtain additional evidence, to the extent necessary, such that the review results is supported by appropriate evidence that is sufficient; or
 - b. If the auditor is not able to obtain sufficient appropriate evidence to support its opinion, the auditor should 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: As appropriate, actions a firm may take include preventive or corrective actions, or a combination, such as actions: (1) to address engagement deficiencies on completed engagements; and (2) 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.

¹⁴ “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.

¹⁵ 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

AT 101 is amended by revising paragraphs .16-.18 to read as follows:

[.16] [Paragraph deleted.]

[.17] [Paragraph deleted.]

[.18] [Paragraph deleted.]

AT 101 is amended by revising footnote 10 to paragraph .46 to read as follows:

.46 The practitioner should establish an understanding with the client regarding the services to be performed for each engagement.^{fn 10} 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.

^{fn 10} See QC 1000.38b.

AT 101 is amended by revising footnote 23 in paragraph.103 to read as follows:

.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 and (b) indicate the engagement team member(s) who performed and reviewed the work.

[fn 23] [Footnote deleted.]

* * *

ET Section 101 – Independence

ET 101 is amended by revising paragraph .01 to read as follows:

.01

* * *

Interpretations under Rule 101–Independence

In performing an attest engagement, a member should consult the rules of his or her state board of accountancy, his or her state CPA society, the U.S. Securities and Exchange Commission (SEC) if the member's report will be filed with the SEC, the U.S. Department of Labor (DOL) if the member's report will be filed with the DOL, the General Accounting Office (GAO) if law, regulation, agreement, policy or contract requires the member's report to be filed under GAO regulations, and any organization that issues or enforces standards of independence that would apply to the member's engagement. Such organizations may have independence requirements or rulings that differ from (e.g., may be more restrictive than) those of the AICPA.

Form 1 - Application for Registration

Form 1 is amended by revising General Instruction 1 to read as follows:

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.

Form 1 is amended by revising General Instruction 3 to read as follows:

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.

Form 1 is amended by adding Item 4.2 to read as follows:

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

Form 2 is amended by adding Item 3.1A to read as follows:

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

Form AP is amended by revising Part IV to read as follows:

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) specialists engaged, not employed, by the Firm; (3) accounting firms in performing the audit of entities in which the issuer has an investment that is accounted for using the equity method; (4) 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 (5) 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.