

RELEASE

PROPOSED AUDITING STANDARD –

ENGAGEMENT QUALITY REVIEW

AND CONFORMING AMENDMENT TO THE
BOARD'S INTERIM QUALITY CONTROL
STANDARDS

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) PCAOB Release No. 2008-002
) February 26, 2008
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) PCAOB Rulemaking
) Docket Matter No. 025
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Summary: The Public Company Accounting Oversight Board (the "Board" or "PCAOB") is proposing an auditing standard, *Engagement Quality Review*, that would supersede the Board's interim concurring partner review requirement, and a conforming amendment to the Board's interim quality control standards.

Public

Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 025 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on May 12, 2008.

Board

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I. Introduction

Section 103 of the Sarbanes-Oxley Act of 2002 ("the Act") directs the PCAOB to include, in the auditing standards that it adopts, requirements that each registered public accounting firm:

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provide a concurring or second partner review and approval of [each] audit report (and other related information), and concurring approval in its issuance, by a qualified person (as prescribed by the Board) associated with the public accounting firm, other than the person in charge of the audit, or by an independent reviewer (as prescribed by the Board).^{1/}

This mandate placed renewed emphasis on the importance to audit quality of an objective "second look" at the engagement before the firm issues its report. In the Board's view, well-performed engagement quality reviews are an important element in establishing a basis for investor reliance on audits. While some audits also may be subject to *post hoc* internal quality reviews by a firm or a PCAOB inspection, neither procedure is a substitute for a well-performed engagement quality review. An engagement quality review is conducted contemporaneously with the engagement and, thus, may correct a problem before the engagement is completed. Furthermore, under the proposed standard, an engagement quality review would be required on every engagement conducted pursuant to the standards of the PCAOB.

Accordingly, the Board examined its existing requirement with a view toward enhancing the quality of this concurring partner review process. Based on this examination, the PCAOB today is proposing an auditing standard, *Engagement Quality Review*, that would supersede the Board's interim concurring partner review requirement, and a conforming amendment to the Board's interim quality control standards.

A. Background

At the time the PCAOB was established, members of the SEC Practice Section ("SECPS")^{2/} of the American Institute of Certified Public Accountants ("AICPA") had a

^{1/} Section 103(a)(2)(A)(ii) of the Act.

^{2/} The SECPS was formed in 1977 as a voluntary membership organization within the AICPA with the objective of improving the quality of practice by CPA firms before the U.S. Securities and Exchange Commission ("SEC" or "Commission"). On January 8, 1990, the AICPA membership adopted a bylaw amendment to require membership in the SECPS by firms that audit "SEC client[s]," as that term was defined in Appendix D, *Revised Definition of an SEC Client*, of the SECPS Reference Manual (SECPS §1000.38). Firms domiciled outside the United States generally were not members of the SECPS.

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requirement to obtain concurring partner reviews of audit reports on the financial statements of SEC registrants.^{3/} The Board adopted, on April 16, 2003, as part of its interim quality control standards, the SECPS requirement for concurring reviews.^{4/} Currently, that requirement applies only to registered firms that were members of the SECPS as of that date.

Under the Board's existing requirement, the objective of the concurring partner review is to review those significant auditing, accounting, and financial reporting matters that come to the reviewer's attention and the resolution of those matters prior to the issuance of the firm's audit report on the financial statements. The existing requirement, among other things, requires the concurring partner reviewer to: (1) discuss significant accounting, auditing and financial reporting matters with the engagement partner; (2) discuss the engagement team's identification and audit of high-risk transactions and account balances; (3) review documentation of the resolution of significant accounting, auditing, and financial reporting matters, including consultation with firm personnel or others outside of the firm; (4) review the summary of unadjusted audit differences; (5) read the financial statements and the auditor's report; and (6) confirm with the engagement partner that there are no significant unresolved matters.

The interim requirement further provides that, "[o]n the basis of th[e] review, the concurring partner reviewer should conclude that no matters that have come to his or her attention would cause the concurring partner reviewer to believe that" the audit was not performed in accordance with the standards of the PCAOB or that the financial statements are not in conformity with generally accepted accounting principles. Under the interim requirement, the concurring partner review should be completed before the audit report is released.

As part of the Board's process of evaluating the interim concurring partner review requirement, the Board sought the advice of its Standing Advisory Group ("SAG") on

^{3/} See SECPS Requirements of Membership, Section 1000.08(f), *Concurring Partner Review of the Audit Report and the Financial Statements of Commission Registrants*, available at http://www.pcaobus.org/Standards/Interim_Standards/Quality_Control_Standards/SEC_PS_1000.08.aspx#f.

^{4/} See PCAOB Rule 3400T, *Interim Quality Control Standards*.

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two separate occasions.^{5/} The discussions (1) suggested ways in which the Board could develop a new standard that would improve the existing interim requirement and (2) considered how smaller registered public accounting firms could provide for or otherwise obtain cost-effective engagement quality reviews. Some SAG members were of the view that the interim requirement did not provide for a thorough review to achieve the objectives of the requirement and that the reviews generally need to be more robust to provide investors with assurance on the quality of audit engagements. Overall, members were supportive of the Board developing a new standard and suggested that the Board establish requirements to govern the engagement quality reviewer's approval of issuance of the audit report. Some members indicated that the review should be performed in a timely manner and that a new standard should provide some guidance on the reviewer's responsibility to assess the sufficiency of the engagement team's documentation.

In addition to input received at these SAG meetings, the Board considered information on this topic from PCAOB inspections when formulating the proposed standard. The significance and the frequency of non-compliance with the Board's standards that PCAOB inspection teams have identified raise questions regarding the effectiveness of the reviews performed pursuant to the Board's existing concurring partner review requirement. Also, documentation of engagement quality reviews was, in some cases, poor, which suggested a need to enhance the existing standard's documentation requirements.

The Board also considered the findings from recent PCAOB enforcement cases. For example, in one matter the Board found that despite assessing an engagement as presenting "greater than normal risk," the firm, among other things, failed to staff the engagement in accordance with PCAOB standards and did not obtain sufficient competent evidential matter to afford a reasonable basis for its opinion on the financial statements.^{6/} Although the Board's order in that case does not reflect any determination about whether the concurring partner review of the engagement violated PCAOB

^{5/} The Standing Advisory Group discussed this topic at meetings held on June 22, 2004, and October 5, 2005. See webcasts at http://www.pcaobus.org/News_and_Events/Webcasts.aspx#20 and http://www.pcaobus.org/News_and_Events/Webcasts.aspx#32, respectively.

^{6/} See In the Matter of Deloitte & Touche LLP, PCAOB Release No. 105-2007-005 (December 10, 2007).

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standards, it does note that the concurring partner review "was not sufficient under the circumstances to provide the firm with reasonable assurance that its personnel complied with PCAOB standards."^{7/}

Furthermore, the Board considered information on this topic from other sources, including the standards in this area published by the International Auditing and Assurance Standards Board ("IAASB") of the International Federation of Accountants^{8/} and the Auditing Standards Board of the AICPA.^{9/}

^{7/} Id.; see also In the Matter of Williams & Webster, P.S., Kevin J. Williams, CPA, and John G. Webster, CPA, PCAOB Release No. 105-2007-001 (June 12, 2007) (finding that the concurring partner failed to exercise due professional care and objectivity in performing his review and concurred with the decision to issue the audit report even though significant issues he identified remained inadequately addressed).

^{8/} Proposed Redrafted International Standard on Auditing ("ISA") 220, *Quality Control for an Audit of Financial Statements*, requires an engagement quality control review, which is defined as "a process designed to provide an objective evaluation . . . of the significant judgments the engagement team made and the conclusions they reached in formulating the auditor's report." The review should include discussions with the engagement partner, a review of the financial statements and the auditor's report, and consideration of whether the auditor's report is appropriate. It also should include a review of selected working papers relating to the significant judgments the engagement team made and the conclusions they reached.

Proposed Redrafted 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*, requires that firms establish policies and procedures for an engagement quality control review that set out the nature, timing, and extent of the review; the criteria for the eligibility of the engagement quality control reviewer; the documentation requirements of the engagement quality control review; and the resolution of differences of opinions.

^{9/} Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control*, contains requirements similar to those in Proposed Redrafted "ISA 220" and Proposed Redrafted "ISQC 1".

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B. Proposed Auditing Standard, *Engagement Quality Review*

The proposed standard would apply to all engagements performed in accordance with the standards of the PCAOB. In addition to requiring certain specified procedures, the proposed standard requires the engagement quality reviewer to assess whether there are areas within the engagement that pose a higher risk that the engagement team failed (1) to obtain sufficient competent evidence or (2) to reach an appropriate conclusion. In such areas, the engagement quality reviewer should evaluate whether the engagement team responded appropriately to the assessed risks, the judgments made were reasonable, and the results of the procedures performed support the engagement team's overall conclusions.

Furthermore, the proposed standard includes a new requirement that the engagement quality reviewer must satisfy before providing concurring approval of issuance. As stated above, under the existing requirement, the reviewer has to conclude that no matters have come to his or her attention that would cause the reviewer to believe that the financial statements are not in conformity with generally accepted accounting principles or that the audit was not conducted in accordance with the standards of the PCAOB. Under the proposed standard, the reviewer must not provide concurring approval of issuance if he or she knows, or should know based upon the requirements of the standard, that the engagement team failed to obtain sufficient competent evidence, the engagement team's overall conclusion or report is inappropriate, or the firm is not independent of its client. Concurring approval of issuance would be required before the firm could grant the client permission to use the engagement report (or communicate a conclusion to a client if no report is issued).

In considering how to improve its existing requirement, while the effectiveness of the standard was the guiding principle, the Board also endeavored to draft a standard that would avoid imposing any unnecessary costs. For example, the approach centers the engagement quality reviewer's attention on higher-risk areas and utilizes engagement documentation already required by PCAOB Auditing Standard No. 3, *Audit Documentation* ("AS No. 3"). Additionally, the proposed standard is designed to address smaller firm needs. For example, the proposal would allow the engagement quality reviewer to be a qualified individual outside the firm.

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II. Overview of the Proposed Standard

The proposed standard would supersede the Board's interim concurring partner review requirement.^{10/} The Board requests comments on all aspects of the proposed standard, and is particularly interested in responses to the specific questions below.

A. **Engagements for Which an Engagement Quality Review Is Required**

Under the Board's interim requirement, concurring partner reviews are to be performed in connection with audits of financial statements of SEC engagements by those firms that were members of the SECPS on April 16, 2003.^{11/} In formulating the proposal, the Board considered whether an engagement quality review should be required for all engagements performed pursuant to the standards of the PCAOB. Due to the benefits to engagement quality, the Board believes that investors and other users of financial information reasonably expect that any engagement performed according to the Board's standards should be subject to an objective review by a qualified person outside of the engagement team.

The proposed standard reflects that belief and requires an engagement quality review for all engagements performed in accordance with the standards of the PCAOB.^{12/} Such engagements include integrated audits of financial statements, audits of financial statements only, and reviews of interim financial information.^{13/}

^{10/} SECPS Requirements of Membership, Section 1000.08(f). If the Board adopts the standard, it will also make a conforming amendment to QC sec. 20 of the Board's interim quality control standards, as described in Appendix 2.

^{11/} SECPS Requirements of Membership, Section 1000.08(f).

^{12/} In contrast, the IAASB standards require an engagement quality control review to be performed for audits of financial statements of listed entities and for the firm to establish policy as to when other types of engagements should be subject to such review.

^{13/} See AU section ("sec.") 722, *Interim Financial Information*. References in this release to AU sections refer to those generally accepted auditing standards, as adopted on an interim basis in PCAOB Rule 3200T.

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Due to the benefits gained from an engagement quality review, the proposed standard also would apply to other audit and attestation^{14/} engagements performed in accordance with the standards of the PCAOB. For example, under the SEC's Regulation AB and related rules, the annual report for a class of asset-backed securities must include from each party participating in the servicing function a report regarding its assessment of compliance with certain specified servicing criteria, and an attestation report by a registered public accounting firm on that assessment.^{15/} The attestation report is to be prepared in accordance with standards on attestation engagements issued or adopted by the PCAOB.^{16/} Under the proposed standard, a registered public accounting firm would be required to obtain an engagement quality review and concurring approval of issuance to issue such an attestation report.

Finally, all registered public accounting firms – not just those that were members of the AICPA SECPS in April 2003 – would be required to comply with the proposed standard.

Questions

1. The proposed standard does not explicitly state an overall objective of an engagement quality review. Should this standard state such an objective? If so, what should be included in the objective?
2. Should an engagement quality review be required for all engagements performed in accordance with the standards of the PCAOB? If not, when should an engagement quality review be required?

B. Qualifications of the Engagement Quality Reviewer

The proposed standard builds upon many of the interim requirement's provisions related to the qualifications of the engagement quality reviewer. Under the proposed

^{14/} See AT sec. 101, *Attest Engagements*, for the definition of an attest engagement.

^{15/} See Securities Exchange Act Rule 13a-18, 17 C.F.R. § 240.13a-18; Item 1122 of Regulation AB, 17 C.F.R. § 229.1122.

^{16/} See Securities Exchange Act Rule 13a-18, 17 C.F.R. § 240.13a-18.

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standard, the engagement quality reviewer may be a partner or another individual in the firm, or an individual outside the firm. As discussed below, the proposed standard notes that the reviewer is required to be independent of the client. The reviewer also must be competent, perform the assigned procedures with integrity, and maintain objectivity with respect to the engagement and the engagement team.^{17/} In addition, the engagement quality reviewer must be an associated person of a registered public accounting firm.

1. Competence

The Board's interim requirement provides, among other things, that the concurring partner should have sufficient technical expertise and experience to perform an objective review of those significant accounting, auditing, and financial reporting matters that come to the reviewer's attention, and contemplates that the reviewer possesses knowledge of relevant specialized industry practices, and SEC rules and regulations in areas pertinent to the engagement. The proposed standard seeks to establish more clearly the level of expertise and experience that is necessary to perform an objective engagement quality review. Accordingly, the proposed standard requires the reviewer to possess the level of knowledge and competence related to accounting, auditing, and financial or other reporting required to serve as the person who has overall responsibility for the same type of engagement.^{18/} For example, a person assigned to perform the engagement quality review for an audit of a public company engaged in oil and gas exploration and development should have experience sufficient to serve as the engagement partner for the audit of a public company in this specialized industry.

^{17/} Under the proposed standard, the firm's quality control policies and procedures should include provisions to provide the firm with reasonable assurance that the engagement quality reviewer has sufficient competence, independence, integrity, and objectivity to perform the engagement quality review in accordance with the standards of the PCAOB. Similarly, ISQC 1 requires that firms establish policies and procedures to address the appointment of the engagement quality control reviewer and to establish his or her eligibility through "the technical qualifications required to perform the role, including the necessary experience and authority."

^{18/} The determination of what constitutes the appropriate level of knowledge and competence should be based on the circumstances of the engagement, including the size or complexity of the business.

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Similar to the interim requirement, the proposed standard allows the engagement quality reviewer to seek assistance from others^{19/} to supplement his or her knowledge and understanding of the issues and risks related to the engagement. For example, the engagement quality reviewer might seek assistance from others when reviewing work performed in certain specialized areas. Similarly, the engagement quality reviewer may seek assistance from others to complete the review on a timely basis, such as for a large engagement. However, the engagement quality reviewer has overall responsibility for the engagement quality review and to provide concurring approval of issuance.^{20/}

2. Independence, Integrity, and Objectivity

To perform an engagement quality review under the proposed standard, the engagement quality reviewer must comply with all applicable independence requirements.^{21/} The engagement quality reviewer would also be required to maintain objectivity with respect to the engagement team and all aspects of the engagement and to perform the review with integrity.^{22/} The proposed standard would prohibit the reviewer from making decisions on behalf of the engagement team, assuming any responsibilities of the engagement team, and supervising the engagement team. The engagement quality reviewer should be able "to take a step back" and conduct the review from the perspective of an outsider "looking in."

Like the interim requirement, the proposed standard would not prohibit the engagement team from consulting with the engagement quality reviewer, and

^{19/} When the engagement quality reviewer seeks assistance from others to supplement his or her knowledge, those consulted must be independent of the client, have integrity, and possess an appropriate level of competence and objectivity.

^{20/} Concurring approval of issuance is discussed in section D.

^{21/} See, e.g., Rule 2-01(f)(7) of Regulation S-X, 17 C.F.R. § 210.2-01(f)(7) (defining "audit engagement team" to include "audit partners," and "audit partner" as certain "partner[s] or persons in an equivalent position," including the "concurring or reviewing partner"); Rule 2-01(c)(6) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(6) (subjecting the engagement quality reviewer to the five-year partner rotation requirement).

^{22/} See ET sec. 102, *Integrity and Objectivity*, and ET sec. 191, *Ethics Rulings on Independence, Integrity, and Objectivity*.

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recognizes that it is often desirable that consultations take place at the time issues arise rather than at the conclusion of the engagement. In such cases, however, care should be taken not to impair the engagement quality reviewer's objectivity. To avoid impairing the reviewer's objectivity, the engagement team could, for example, develop an initial resolution of the issue prior to commencing discussions with the reviewer. If the reviewer's objectivity becomes impaired, the firm should replace the engagement quality reviewer.

Furthermore, the Board expects the engagement quality reviewer to exercise due professional care and professional skepticism without considering his or her professional status in relation to that of the engagement partner, so that the reviewer is in a position to challenge the engagement team, if necessary.

3. An Associated Person of a Registered Public Accounting Firm

The proposed standard would require the engagement quality reviewer to be an associated person of either the firm issuing the engagement report or another registered public accounting firm.^{23/} Accordingly, the reviewer could be a partner or employee of the firm issuing the report, an individual associated with another registered firm, or an individual who becomes associated with the firm issuing the report by performing the review.^{24/} A person not already associated with a firm could enter into a relationship with

^{23/} Under PCAOB Rule 1001(p)(1), an associated person of a registered public accounting firm is "any individual, proprietor, partner, shareholder, principal, accountant, or professional employee of a public accounting firm, or any independent contractor that, in connection with the preparation or issuance of any audit report – (1) shares in the profits of, or receives compensation in any other form from, that firm; or (2) participates as agent on behalf of such accounting firm in any activity of that firm; provided, however, that these terms do not include a person engaged only in clerical or ministerial tasks or a person whom the public accounting firm reasonably believes is a person primarily associated with another registered public accounting firm."

^{24/} A registered public accounting firm has an obligation to secure and enforce consents to cooperate with the Board from each associated person of the firm, see Section 102(b)(3) of the Act, including those who become associated with the firm by performing the review. The Board also may directly sanction any such person who fails to cooperate in an investigation or inspection. See Section 105(b)(3) of the Act and PCAOB Rules 5110 and 4006.

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the firm issuing the report such that the person would become associated with that firm by performing the review. Specifically, a person not already associated with a firm would become associated with the firm issuing the report if *he or she* (rather than, or in addition to, his or her firm or other employer): (1) receives compensation from the firm issuing the report for performing the review or (2) performs the review as agent for the firm issuing the report.^{25/} For example, if the firm issuing the report contracts directly with an employee of an unregistered accounting firm to perform the engagement quality review, that person would become associated with the firm issuing the report by virtue of that independent contractor relationship. Any qualified person could thus perform the review, regardless of whether he or she was associated with a registered public accounting firm before agreeing to perform the engagement quality review.

Questions

3. Are the qualifications of an engagement quality reviewer appropriately described in the proposed standard? If not, how should they be revised?
4. Should the proposed standard allow the engagement team to consult with the engagement quality reviewer during the engagement? Would such consultation impair the reviewer's objectivity?

C. The Engagement Quality Review Process

The engagement quality review described in the proposed standard is a risk-based approach that would require the reviewer to focus on the significant judgments made by the engagement team, as well as the conclusions that the engagement team reached in forming its overall conclusion on the engagement and preparing the engagement report.

1. Scope of Review

Under the proposed standard, the engagement quality review process should include an evaluation of the significant judgments made by the engagement team and the conclusions reached in forming the overall conclusion on the engagement. To identify and evaluate the significant judgments and conclusions, the engagement quality reviewer should have discussions with the engagement partner and with other members

^{25/} See PCAOB Rule 1001(p)(1).

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of the engagement team, as necessary. This requirement to evaluate significant judgments is similar to the requirements of the related standards of the IAASB.

The proposed standard also specifies certain procedures, some of which are similar to those described in the existing requirement, that should be a part of every review process. Such procedures include, for example, evaluating engagement planning, including the judgments made about materiality and the identification of significant risks; reading the financial statements (and related disclosures), management's report on internal control, or other information that is the subject of the engagement; reviewing the engagement team's evaluation of the firm's independence in relation to the engagement; and reviewing the engagement completion document, among other things.^{26/} These procedures also are similar, in many respects, to those contained in the IAASB standards.

These procedures, however, are not a comprehensive list of all required procedures under the proposed standard. Based on these procedures (and other relevant knowledge of the reviewer), the reviewer would be required to assess whether there are areas within the engagement that pose a higher risk that the engagement team failed to obtain sufficient competent evidence or to reach an appropriate conclusion.

For the areas that pose such risk, the engagement quality reviewer should evaluate whether the engagement team performed procedures that were responsive to the assessed risks, the judgments made by the engagement team were reasonable in the circumstances, and the results of the procedures support the engagement team's conclusion. The amount of work necessary to satisfy the proposed standard's requirement would, therefore, depend on the specific risks posed by the engagement. This risk-based approach reflects the Board's belief that the engagement quality review should be rigorous enough to identify significant problems in a timely manner for correction, without imposing unnecessary costs.

^{26/} AS No. 3 requires the auditor to identify all significant findings or issues in an engagement completion document.

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Questions

5. Are the descriptions of the scope and extent of engagement quality review procedures contained in the proposed standard appropriate? If not, how should they be changed?
6. Is the risk-based approach to the engagement quality review described by the proposed standard sufficient to identify significant engagement problems? If not, how should the proposed standard be changed?

2. Review of Engagement Documentation

The proposed standard would improve the requirements related to the engagement quality reviewer's evaluation of the engagement documentation. The Board's existing interim requirement makes reference to certain documentation to be reviewed by the concurring partner. However, the interim requirement does not explicitly direct the reviewer to evaluate whether the engagement documentation complies with audit documentation requirements or supports the conclusions reached by the engagement team. When the Board adopted AS No. 3, it stated:

First and foremost, the objectives of this audit documentation standard are to improve audit quality and to enhance public confidence in the quality of auditing and other engagements. Complete and thorough audit documentation improves the quality of the work performed in many ways. One important example is that quality audit documentation is a record of the actual work performed, which provides assurance that the auditor accomplished the planned objectives. Further, the need to document the procedures performed, the evidence obtained, and the conclusions reached demands a disciplined approach to planning and performing the engagement. Also, audit documentation facilitates the reviews performed by supervisors, managers, partners, and PCAOB inspectors.^{27/}

Accordingly, the Board believes that an important aspect of the engagement quality review should be to enhance the likelihood that the engagement team has appropriately documented its work in the areas reviewed by the engagement quality

^{27/} See *Audit Documentation and Amendment to Interim Auditing Standards*, PCAOB Release No. 2004-006 (June 9, 2004).

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reviewer. The proposed standard therefore requires the engagement quality reviewer to evaluate, for those areas reviewed, whether the engagement team's documentation supports the conclusions reached, indicates that the engagement team responded appropriately to matters that present a significant risk, and meets the documentation requirements of AS No. 3.

Question

7. Are the proposed requirements for the review of the engagement team's documentation appropriate? If not, how should they be changed?

3. Timing of the Review

Under the interim requirement, the concurring partner review is to be completed before release of the auditor's report. Similarly, the proposed standard requires the engagement quality reviewer to complete his or her review prior to providing concurring approval of issuance.^{28/} Beyond that, the proposed standard does not prescribe the timing of the review. The Board recognizes that the efficiency of the review can be affected by the size and complexity of the engagement and other considerations. Furthermore, the Board believes the engagement quality review could be more effective if the review is performed shortly after the engagement team's resolution of significant issues.

Question

8. Is the description of the timing of the engagement quality review, as proposed, appropriate? If not, how should it be changed?

D. Concurring Approval of Issuance

Under the Act, the Board's standard on engagement quality review must require a qualified person to provide concurring approval of issuance of each audit report. Accordingly, the proposed standard provides that the firm must not grant permission to the client to use the engagement report (or communicate the engagement conclusion to the client) before the engagement quality reviewer provides concurring approval. This

^{28/} Concurring approval of issuance is discussed in the following section.

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proposed requirement reflects the Board's belief that the engagement quality review should serve as a meaningful opportunity to identify problems in time to correct them.

The proposal would establish a new standard that the engagement quality reviewer must meet in order to provide a concurring approval of issuance. Under the interim requirement, the concurring partner reviewer is to conclude, based on his or her review, that no matters have come to his or her attention that would cause the reviewer to believe that the audit was not performed in accordance with the standards of the PCAOB or that the financial statements are not in conformity with generally accepted accounting principles. In contrast, the proposed standard provides that the engagement quality reviewer must not provide concurring approval of issuance if he or she knows, or should know based upon the requirements of the standard, that (1) the engagement team failed to obtain sufficient competent evidence in accordance with the standards of the PCAOB, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement,^{29/} (3) the firm's report, if a report is to be issued, is not appropriate in the circumstances, or (4) the firm is not independent of its client. The Board recognizes that differences of opinion could occur between the engagement team and the engagement quality reviewer. If those differences have not been satisfactorily resolved, the engagement quality reviewer must not provide concurring approval.

This proposed requirement is intended to focus auditors on those matters that must be corrected before an audit report is issued (or before an engagement conclusion is communicated to the client). At the same time, it recognizes that the engagement quality reviewer's role is not to perform procedures amounting to a re-audit. Accordingly, under the proposed standard, the engagement quality reviewer can provide concurring approval of issuance unless he or she: (1) has actual knowledge of one of the significant problems described above, or (2) should have known of such a problem after performing the procedures required by the proposed standard.

^{29/} Inappropriate conclusions on the subject matter of the engagement would include, for example, a failure to appropriately modify the engagement conclusion in response to: (1) a material departure from generally accepted accounting principles or (2) a material weakness in internal control over financial reporting.

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Question

9. Is the standard for the engagement quality reviewer's concurring approval of issuance appropriate? If not, how should it be changed?

E. Documentation of an Engagement Quality Review

PCAOB inspection teams have observed apparent deficiencies in the documentation of the concurring partner review, which prevented a determination as to whether the scope of the review was appropriate and also may have contributed to the firm's failure to properly address the concurring partner's findings.^{30/} Academic research also has indicated deficiencies in documentation of the concurring partner review. For example, in recent academic research, the authors observed that "the firm's checklists or practice aids showed substantial variability. The content and extensiveness of the checklists or practice aids varied. Overall, they are not very detailed, and in most cases, are checklists that only require initials or signature of the concurring partner to indicate completion of the . . . required procedures . . ."^{31/}

The Board's interim requirement provides that the engagement documentation should contain evidence that the reviewer has complied with the firm's policies in conducting a concurring partner review, including documentation of the reviewer's conclusion. The proposed standard is more specific with regard to the documentation of the engagement quality review. Under the proposed standard, the engagement documentation should indicate:

- Who performed the review;
- The areas of the engagement subject to the review;
- The procedures performed by the reviewer;

^{30/} See PCAOB Release No. 2007-010, *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms* (October 22, 2007).

^{31/} See Kathryn K. Epps and William F. Messier, Jr., "Engagement Quality Reviews: A Comparison of Audit Firm Practices," *Auditing: A Journal of Practice & Theory*, Vol. 26, No.2 (2007) pp.167-181.

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- When the review procedures were performed;
- The results of the review procedures; and
- Whether the engagement quality reviewer provided concurring approval of issuance.

Furthermore, the requirements related to retention of and subsequent changes to audit documentation in AS No. 3 apply with respect to the documentation of the engagement quality review under the proposed standard.

Questions

10. Are the documentation requirements for an engagement quality review appropriate? If not, how should they be changed?
12. Should the proposed standard require documentation of the engagement quality review to comply with other provisions contained in AS No. 3? If so, which provisions should be applicable?

III. Effective Date of the Proposed Standard and Related Amendment

The Board is proposing that this standard, *Engagement Quality Review*, and the conforming amendment, be effective, subject to approval by the SEC, for engagement reports issued (or the communication of an engagement conclusion, if no report is issued) on or after December 15, 2008. Early implementation of the standard and the conforming amendment would be permitted. The Board requests comment on this proposed effective date.

IV. Opportunity for Public Comment

The Board will seek comment for a 75-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 025 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on May 12, 2008.

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The Board will carefully consider all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are rules of the Board under the Act.

On the 26th day of February, in the year 2008, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

February 26, 2008

APPENDIX 1 – *Proposed Auditing Standard – Engagement Quality Review*

APPENDIX 2 – *Proposed Amendment to the Interim Quality Control Standards*

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APPENDIX 1 – *Proposed Auditing Standard* – Engagement Quality Review

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

ENGAGEMENT QUALITY REVIEW

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Auditing Standard No. X

Supersedes SECPS Requirements of Membership § 1000.08(f).

Engagement Quality Review

Introduction

1. An engagement quality review and concurring approval of issuance are required for each engagement performed and completed in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB").

Qualifications of an Engagement Quality Reviewer

2. An engagement quality reviewer may be a partner of the firm that issues the engagement report (or communicates an engagement conclusion, if no report is issued),^{1/} another individual in the firm, or an individual outside the firm. The engagement quality reviewer must be an associated person of a registered public accounting firm.

3. As described below, an engagement quality reviewer must have competence, independence, integrity, and objectivity.

Note: The firm's quality control policies and procedures should include provisions to provide the firm with reasonable assurance that the engagement quality reviewer has sufficient competence, independence, integrity, and objectivity to perform the engagement quality review in accordance with the standards of the PCAOB.

4. *Competence.* The engagement quality reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial or other

^{1/} An engagement report might not be issued, for example, in connection with a review of interim financial information. See paragraph .03 of AU section ("sec.") 722, *Interim Financial Information*.

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reporting required to serve as the person who has overall responsibility for the same type of engagement.^{2/}

5. *Independence, Integrity, and Objectivity.* The engagement quality reviewer must be independent of the company, perform the engagement quality review with integrity, and maintain objectivity with respect to the engagement and the engagement team.

Note: The reviewer may seek assistance from others to perform the engagement quality review. Personnel assisting the engagement quality reviewer also must be independent, perform the assigned procedures with integrity, and maintain objectivity with respect to the engagement and the engagement team.

6. To maintain objectivity, the engagement quality reviewer should not: (a) make decisions on behalf of the engagement team; (b) assume any of the responsibilities of the engagement team; or (c) supervise the engagement team. The person with overall responsibility for the engagement (e.g., the engagement partner in an audit of financial statements) remains responsible for the engagement and its performance, notwithstanding the involvement of the engagement quality reviewer.

Note: The engagement team may consult with the engagement quality reviewer on matters during the course of the engagement. When participating in such consultations, the engagement quality reviewer should not participate in a manner that would compromise his or her objectivity with regard to the engagement.

Engagement Quality Review Process

7. The engagement quality review should include an evaluation of the significant judgments made by the engagement team and the conclusions reached in forming the overall conclusion on the engagement, and in preparing the engagement report, if a report is to be issued. To identify and evaluate the significant judgments and conclusions, the engagement quality review should include discussions with the person

^{2/} PCAOB interim quality control standards describe the competencies required of a person who has the overall responsibility for an engagement (or any practitioner-in-charge of an attest engagement). See QC section ("sec.") 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement*.

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with overall responsibility for the engagement, discussions with other members of the engagement team as necessary, and other procedures, as described in paragraphs 8 and 9.

8. As part of performing the engagement quality review, the engagement quality reviewer should:

- a. Obtain an understanding of the firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process.
- b. Obtain an understanding of the company's business, significant activities during the current year, and significant financial reporting issues and risks.
- c. Review the engagement team's evaluation of the firm's independence in relation to the engagement.
- d. Evaluate engagement planning, including (1) the judgments made about materiality and the effect of those judgments on the engagement strategy and (2) the identification of significant risks, including fraud risks, and the plan for and performance of engagement procedures in response to those risks.
- e. Evaluate judgments made about (1) the materiality and disposition of corrected and uncorrected identified misstatements and (2) the severity and disposition of identified control deficiencies.
- f. Determine if appropriate consultations have taken place on difficult or contentious matters. Review the documentation, including conclusions, of such consultations.
- g. Read the financial statements, management's report on internal control, or other information that is the subject of the engagement and the engagement report (if an engagement report is to be issued) for the period covered by the engagement and for the prior period.

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- h. Read other information in documents containing financial statements that are the subject of the engagement to be filed with the SEC^{3/} and evaluate whether the engagement team has taken appropriate action with respect to material inconsistencies with the financial statements or material misstatements of fact of which the engagement quality reviewer is aware.
- i. Determine if appropriate matters have been communicated, or identified for communication to the audit committee, management, and other parties, such as regulatory bodies.
- j. Review the engagement completion document^{4/} and confirm with the person with overall responsibility for the engagement that there are no significant unresolved matters.

9. Based on the procedures performed in accordance with paragraphs 7 and 8, and other relevant knowledge possessed by the engagement quality reviewer, the engagement quality reviewer should assess whether there are areas within the engagement that pose a higher risk that the engagement team has failed to obtain sufficient competent evidence or reached an inappropriate conclusion. For the areas that pose such risk, the engagement quality reviewer should evaluate whether the engagement team performed procedures that were responsive to the assessed risks, the judgments made by the engagement team were reasonable in the circumstances, and the results of the procedures support the engagement team's overall conclusion.

10. *Evaluate Engagement Documentation.* The reviewer should evaluate whether the engagement documentation of the matters that were subject to the engagement quality review procedures –

- a. Is appropriate in the circumstances and consistent with the requirements of PCAOB Auditing Standard No. 3, *Audit Documentation* ("AS No. 3"),

^{3/} See paragraphs .02 and .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, and paragraph .18f of AU sec. 722, *Interim Financial Information*. Also, see AU sec. 711, *Filings Under Federal Securities Statutes*.

^{4/} PCAOB Auditing Standard No. 3, *Audit Documentation*, requires the auditor to identify all significant findings or issues in an engagement completion document.

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- b. Indicates that the engagement team responded appropriately to matters that present a significant risk, and
- c. Supports the conclusions reached by the engagement team with respect to the matters reviewed and the conclusions and representations in the engagement report.

11. *Timing of the Review.* The engagement quality reviewer must complete his or her review prior to providing concurring approval of issuance.

Note: The engagement quality review procedures may be performed at various points throughout the conduct of the engagement. For example, the engagement quality reviewer might review the engagement team's planning of the engagement before the engagement team implements the engagement plan. Such timely review might facilitate the effectiveness of the overall engagement.

Concurring Approval of Issuance

12. The engagement quality reviewer must not provide concurring approval of issuance if he or she knows, or should know based upon the requirements of this standard, that (1) the engagement team failed to obtain sufficient competent evidence in accordance with the standards of the PCAOB, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the firm's report, if a report is to be issued, is not appropriate in the circumstances, or (4) the firm is not independent of its client.

13. The firm must not grant permission to the client to use the engagement report (or communicate an engagement conclusion to its client, if no engagement report is issued) before the engagement quality reviewer provides concurring approval of issuance.^{5/}

^{5/} Concurring approval of issuance by the engagement quality reviewer also is required when reissuance of an engagement report requires the auditor to update his or her procedures for subsequent events. In that case, the engagement quality reviewer should update the engagement quality review by addressing those matters related to the subsequent events procedures.

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Documentation of an Engagement Quality Review

14. Documentation of an engagement quality review should be included in the engagement documentation and should include information concerning:
- a. Who performed the engagement quality review,
 - b. The areas of the engagement subject to the engagement quality review,
 - c. The procedures performed by the engagement quality reviewer,
 - d. When the review procedures were performed,
 - e. The results of the review procedures, and
 - f. Whether the engagement quality reviewer provided concurring approval of issuance.
15. The requirements related to retention of and subsequent changes to audit documentation in AS No. 3 apply with respect to the documentation of the engagement quality review.

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APPENDIX 2 – Proposed Amendment to the Interim Quality Control Standards

The following proposed amendment relates to QC sec. 20 of the Board's interim quality control standards.

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

The third sentence of paragraph 18 of QC sec. 20 is replaced with the following sentence:

These policies and procedures also should address engagement quality review pursuant to PCAOB Auditing Standard No. xx, *Engagement Quality Review*.