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PROPOSED AMENDMENTS RELATING TO THE SUPERVISION OF AUDITS INVOLVING OTHER AUDITORS

AND PROPOSED AUDITING STANDARD—

DIVIDING RESPONSIBILITY FOR THE AUDIT WITH ANOTHER ACCOUNTING FIRM

PCAOB Release No. 2016-002
April 12, 2016

PCAOB Rulemaking
Docket Matter No. 042

Summary: The Public Company Accounting Oversight Board ("PCAOB" or "Board") is proposing to amend its auditing standards to strengthen the requirements that apply to audits that involve accounting firms and individual accountants outside the accounting firm that issues the audit report. The amendments are designed to improve the quality of audits in these circumstances and to align the applicable requirements with the PCAOB's risk-based, supervisory standards.

Public Comment: Interested persons may submit written comments to the Board. Comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 042 in the subject or reference line and should be received by the Board by July 29, 2016.

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Major Proposed Amendments:

The Board is proposing for public comment:

(i) To supersede:

- AS 1205 (currently AU sec. 543), *Part of the Audit Performed by Other Independent Auditors*; and
- AI 10, *Part of the Audit Performed by Other Independent Auditors: Auditing Interpretations of AS 1205* (currently AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543*);

(ii) To amend:

- AS 1201 (currently Auditing Standard No. 10), *Supervision of the Audit Engagement*;
- AS 1215 (currently Auditing Standard No. 3), *Audit Documentation*;
- AS 1220 (currently Auditing Standard No. 7), *Engagement Quality Review*; and
- AS 2101 (currently Auditing Standard No. 9), *Audit Planning*; and

(iii) To issue a new auditing standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*.

(B) *Including the other auditors in the engagement team and supervising their work under AS 1201*. This standard governs the auditor's supervision of an audit engagement, including the work of other auditors who are members of the same engagement team, wherever they are located. AS 1201, as it relates to the supervision of other auditors on the engagement team, contains these requirements:

- The engagement partner and others who assist the engagement partner in supervising the audit should:
  - o Inform the engagement team members of their responsibilities for the work they are to perform;
  - o Direct the engagement team members to inform the engagement partner and supervisors of important issues arising during the audit; and
  - o Review the engagement team members' work.[22]
- The engagement partner and others who assist the engagement partner in supervising the audit should determine the extent of supervision necessary. Under this standard, requirements for supervision are risk-based and scalable, and the necessary extent of supervision varies depending on, for example, the associated risks of material misstatement, the nature of the work performed, and the qualifications of individuals involved.[23]
- The engagement partner may seek assistance from other appropriate engagement team members in fulfilling his or her supervisory responsibilities ("supervisory team members").[24] The supervisory team members can be from the partner's firm or from outside the firm.

(C) *Dividing responsibility for the audit with another accounting firm*. AS 1205 also governs audits in which the lead auditor divides responsibility with another accounting firm that issues a separate audit report on the financial statements of one or more subsidiaries, divisions, branches, components,

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22 *See* AS 1201.05.

23 *See* AS 1201.06.

24 *See* AS 1201.04.

or investments included in the company's financial statements.[25] The requirements of AS 1205 that apply under these circumstances are more limited than the requirements that apply to the lead auditor's use of the work and reports of other auditors when the lead auditor assumes responsibility for that work (discussed in item A above). For example, AS 1205 does not require the lead auditor to obtain, review, and retain certain information from the accounting firm with which the lead auditor divides responsibility for the audit (which is required when the lead auditor assumes responsibility for another firm's work under AS 1205[26]).

B. Current Practice

This section describes the state of practice – including the evolution of audit practices and related inspection findings – that the Board and its staff have observed over the past several years through PCAOB oversight activities (including through observations from audit inspections and enforcement cases). Section C discusses the reasons for change that underlie the amendments the Board is proposing.

1. Evolution of Auditing Practice at Accounting Firms

Auditors around the world, even when they perform audit procedures that are required to comply with PCAOB standards, may be influenced by international and home country auditing standards. With respect to the use of other auditors, the standards of the International Auditing and Assurance Standards Board ("IAASB") and the AICPA's Auditing Standards Board ("ASB"), (International Standard on Auditing ("ISA") 600[27] and AU-C Section 600[28]), establish requirements for "group audits."[29] ISA 600 and AU-C Section 600 were developed in the wake of several significant frauds that

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[25] In these situations, SEC rules require that the other accounting firm's report be filed with the SEC. *See* Rule 2-05 of Regulation S-X, 17 C.F.R. 210.2-05.

[26] *See* AS 1205.12.

[27] ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, effective for audits of group financial statements for periods beginning on or after December 15, 2009.

[28] AU-C Section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, effective for audits of group financial statements for periods ending on or after December 15, 2012.

[29] Under ISA 600 and AU-C 600, group audits are audits of "group financial statements" consisting of at least two "components." Group audits generally are performed by a "group engagement team" and one or more "component auditors" and may involve a single firm or multiple firms.

occurred in the early 2000s and involved multinational groups of companies, audited by multiple accounting firms.[30]

The IAASB is continuing to assess the need for change in this area. Recently, the IAASB issued a request for comment on identified areas of potential improvement in the standards for group audits,[31] which was informed by, among other things, persistent deficiencies in group audits reported by the International Forum of Independent Audit Regulators.[32]

Meanwhile, the Board has observed through its oversight activities that, after the PCAOB adopted its standards on risk assessment and after the IAASB and ASB issued their new standards, some accounting firms, particularly some of the largest firms that work extensively with other auditors, revised their policies, procedures, and guidance ("methodologies") for using other auditors. These methodologies are based primarily on the requirements of ISA 600 and include certain other procedures for audits under PCAOB standards.[33] The Board also observed differences among firms' methodologies,

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[30] *See, e.g.*, *Koninklijke Ahold N.V. (Royal Ahold), A. Michiel Meurs and Cees van der Hoeven, and Johannes Gerhardus Andreae*, SEC Accounting and Auditing Enforcement Release ("AAER") No. 2124 (Oct. 13, 2004); *Lernout & Hauspie Speech Products*, AAER No. 1729 (Mar. 4, 2003); *Lernout & Hauspie Speech Products*, AAER No. 1648 (Oct. 10, 2002); *In re Parmalat Securities Litigation*, 04 Civ. 0030 (S.D.N.Y. June 28, 2005). *See also* Michael J. Jones, ed., *Creative Accounting, Fraud and International Accounting Scandals* (2011) (Part B of the book covers 58 high-profile accounting scandals across 12 countries, including the Royal Ahold and Parmalat cases).

[31] *See* IAASB, *Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits* (Dec. 2015). *See also* IAASB, *Work Plan for 2015–2016: Enhancing Audit Quality and Preparing for the Future* (Dec. 2014), 7 ("Concern [with ISA 600] has been expressed about: [t]he extent of the group auditor's involvement in the work of the component auditor ...; [c]ommunication between the group auditor and the component auditor; [a]pplication of the concept of component materiality; [i]dentifying a component in complex situations; and [w]ork effort of the component auditor.").

[32] *See* paragraph 7 of IAASB, *Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits* (Dec. 2015).

[33] For example, for audits under PCAOB standards, these methodologies often require engagement teams to determine the sufficiency of the firm's participation in the audit. *See also* Appendix 4 of this release, which compares the Board's proposed amendments to the analogous standards of the IAASB and ASB.

for example, in their approaches to determining whether the firm's participation in an audit is sufficient for it to serve as lead auditor.

In addition, some firms have added requirements that in some respects go beyond those of PCAOB, IAASB, and ASB standards. Other firms, however, have maintained methodologies generally based on AS 1205.[34]

2. Observations from Audit Inspections and Enforcement Cases

PCAOB staff have inspected the work of auditors who use other auditors, for example, by reviewing the scope of the work that is performed by the other auditor, the planning and instructions provided to the other auditor, and the degree of supervision (including review) of the other auditor. The PCAOB also has inspected the work of other auditors, for example, when it conducts inspections abroad and reviews work performed by non-U.S. auditors at the request of a U.S.-based lead auditor. In some cases, PCAOB staff have inspected the work performed by both the lead auditor and other auditors on the same audit. In many cases, but not always, the lead auditor was a U.S. firm while the other auditor was located in another jurisdiction. Observations regarding the work of lead auditors and other auditors from inspections and enforcement actions are described in more detail below.

(i) Other Auditors

Over the past several years, PCAOB inspections staff have observed significant audit deficiencies in the work performed by other auditors. For example, in 2013, inspections staff identified significant audit deficiencies in more than 40 percent[35] of the inspected work performed for lead auditors by non-U.S. GNFs. According to a recent analysis, the rate of deficiencies in inspected audits in 2011–2013 was generally higher for non-U.S. GNFs than for U.S. GNFs.[36]

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[34] *See* Section IV.A.3 below for a more detailed discussion of the methodologies.

[35] The rates in 2011-2013 were 32, 38, and 42 percent, respectively. *See Audit Committee Dialogue*, PCAOB Release No. 2015-003, at 9 (May 7, 2015) (graph entitled "Deficiencies in Non-U.S. Referred Work"). The issuer audit engagements and aspects of the work inspected are selected based on a number of risk-related and other factors. Due to the selection process, the deficiencies included in inspections reports are not necessarily representative of the inspected firms' issuer audit engagement practice.

[36] *See* Lewis H. Ferguson, *Big Four Audit Quality Can Differ Widely — Even at the Same Firm* (Nov. 17, 2015) (Mr. Ferguson is a Board member of the PCAOB).

Inspections of the work performed by other auditors have revealed deficiencies such as noncompliance with the lead auditor's instructions and failure to communicate significant accounting and auditing issues to the lead auditor. In addition, deficiencies have been identified in other auditors' compliance with other PCAOB standards governing a variety of audit procedures. These failures in audit performance occurred in critical audit areas that are frequently selected for inspection, including revenue, accounts receivable, internal control over financial reporting, and accounting estimates including fair value measurements. For example, in a number of instances, other auditors failed to perform sufficient procedures in auditing the revenue of a company's business unit, including, with respect to evaluating the revenue recognition policy of a business unit, testing the occurrence of revenue, and testing the operating effectiveness of the business unit's controls over revenue. In a recent Board enforcement case, one other auditor failed both to ensure he was technically proficient and to supervise his assistants in accordance with PCAOB standards.[37] More recently, however, there are some indications of decreasing inspection-observed deficiencies, as discussed in Section II.B.2(iv) below.

(ii) Lead Auditor

Over the years, there have been numerous observations from inspections and enforcement activities where the lead auditor failed, under existing PCAOB standards, to appropriately determine the sufficiency of its participation in an audit to warrant serving as lead auditor. These deficiencies occurred at large and small firms, domestic as well as international. In the most egregious examples, the lead auditor failed to perform an audit or participated very little in the audit and instead issued an audit report on the basis of procedures performed by other auditors.[38] In these audits, the auditor failed to appropriately determine that it could serve as the lead auditor when all or a substantial portion of the financial statements were audited by another auditor.

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[37] *See Akiyo Yoshida, CPA*, PCAOB Release No. 105-2014-024 (Dec. 17, 2014).

[38] For enforcement cases, *see, e.g.*, *Michael T. Studer, CPA, P.C. and Michael T. Studer, CPA*, PCAOB Release No. 105-2012-007 (Sept. 7, 2012); *Bentleys Brisbane Partnership and Robert John Forbes, CA*, PCAOB Release No. 105-2011-007 (Dec. 20, 2011); *Dohan + Company, CPAs, Steven H. Dohan, CPA, Nancy L. Brown, CPA, and Erez Bahar, CA*, SEC AAER No. 3232 (Jan. 20, 2011). Some of the standards violated in the enforcement cases cited in this release were predecessor standards to current PCAOB standards. The descriptions of inspection deficiencies are based on certain accounting firm inspection reports (portions of which are available on the PCAOB's website), and on the PCAOB's experience with inspecting different firms.

There also have been findings in which the lead auditor failed to assess, or adequately assess, the qualifications of other auditors' personnel who participated in the audit. For example, PCAOB oversight activities have revealed situations in which the other auditors' personnel lacked the necessary industry experience or knowledge of PCAOB and SEC rules and standards (including independence requirements) and the applicable financial reporting framework to perform the work requested by the lead auditor. Other examples include audits in which: (i) the lead auditor failed to obtain, review, and retain the results of the other auditor's procedures relating to fraud risk factors;[39] (ii) the lead auditor failed to provide specific instructions to other auditors, including detailed audit plans, appropriate modifications to audit plans based on identified risks, the audit objectives to be accomplished, or the need to maintain proper documentation;[40] and (iii) the lead auditor failed to adequately supervise the work of foreign audit staff, in circumstances in which the engagement partner did not speak, read, or write the language used by the foreign staff.[41] More recently, there are indications of increased involvement by some firms in the supervision of other auditors, as discussed in Section II.B.2(iv) below.

(iii) Divided Responsibility Audits

Audits in which the lead auditor divides responsibility with one or more other accounting firms are relatively uncommon.[42] Such division of responsibility between auditors might occur, for example, in the year when an issuer acquires a company

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[39] *See Ron Freund, CPA*, PCAOB File No. 105-2009-007, at 1 (Jan. 26, 2015) (citing a violation of AU sec. 543.12b (reorganized as AS 1205.12b) and observing that "'the principal auditor must obtain, and review and retain, the following information from the other auditor: … b. A list of significant fraud risk factors, the auditor's response, and the results of the auditor's related procedures ….'").

[40] *See, e.g., Child, Van Wagoner & Bradshaw, PLLC, Russell E. Anderson, CPA, and Marty Van Wagoner, CPA*, SEC AAER No. 3637 (Feb. 11, 2015); *Sherb & Co., LLP, Steven J. Sherb, CPA, Christopher A. Valleau, CPA, Mark Mycio, CPA, and Steven N. Epstein, CPA*, SEC AAER No. 3512 (Nov. 6, 2013).

[41] *See, e.g.*, *Acquavella, Chiarelli, Shuster, Berkower & Co., LLP*, PCAOB Release No. 105-2013-010 (Nov. 21, 2013); *David T. Svoboda, CPA*, PCAOB Release No. 105-2013-011 (Nov. 21, 2013).

[42] Based on PCAOB staff analysis of SEC filings as of May 26, 2015, Form 10-K filings showed approximately 30 and 38 audits in which the lead auditor divided responsibility with another auditor in fiscal years 2014 and 2013, respectively. Form 20-F filings showed approximately 20 such audits in each of fiscal years 2014 and 2013.

audited by another auditor.[43] Because divided responsibility audits are infrequent, they have not been a significant focus of PCAOB inspections and have not resulted in significant findings.

(iv) Evolution of Inspection Findings

As noted above, some firms, particularly larger firms affiliated with global networks, have increased their supervision of other auditors in light of new standards such as ISA 600 and AU-C Section 600. More recently, some larger U.S. firms have made further changes to their audit methodologies in response to deficiencies identified by PCAOB inspections. Specifically, some firms have encouraged a greater level of supervision by the lead auditor, such as frequent comprehensive communications with other auditors and review of other auditors' work papers in the areas of significant risk.

There are some preliminary indications from the Board's inspections that these firms' recent revisions to methodologies to increase the lead auditor's supervision of the other auditor's work may have contributed to a decline in inspection-observed audit deficiencies at foreign affiliates of those firms with respect to work these affiliates perform at the lead auditor's request. In 2014, for example, PCAOB inspections staff observed a decrease in the number of significant audit deficiencies in work performed by other auditors. Thus, the changes to the methodologies of some firms appear to have contributed to some improvements in the quality of audits. However, not all firms have significantly changed their methodologies. Also, PCAOB staff continue to identify significant deficiencies in the work of lead auditors related to the lead auditors' use of other auditors, and deficiencies in the work of other auditors in the U.S. and abroad.

C. Reasons to Improve Auditing Standards

After AS 1205 was originally issued, the increasing globalization of business, especially among large public companies, has led to expanded use of other auditors and increasingly significant roles for other auditors within the audit. When other auditors participate in an audit, it is important for investor protection that the lead auditor assure that the audit is performed in accordance with PCAOB standards and that sufficient appropriate evidence is obtained through the work of the lead auditor and other auditors to support the lead auditor's opinion in the audit report. Among other things, this means that the lead auditor should be appropriately involved in the audit so that the work of all audit participants is properly supervised, and so that the results of the work are properly evaluated. Lack of adequate lead auditor supervision can result in deficient audits.

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[43] *See, e.g.*, SEC, Form 10-K for American Airlines Group, Inc., Annual Report for the Fiscal Year Ended December 31, 2013 (Feb. 27, 2014), at 96.

As noted above, some firms have made changes in their audit methodologies regarding the use of other auditors. However, **other firms that have not made significant improvements may have greater risk of lower quality audits when they use other auditors.**

Additionally, observations from PCAOB oversight activities indicate that further improvements may be needed. PCAOB staff continue to identify deficiencies in the work of other auditors in critical audit areas, deficiencies that lead auditors had not identified or sufficiently addressed. In some cases, these deficiencies occurred even when lead auditors did not violate existing requirements related to the use of other auditors, for example if the lead auditor performed the procedures described in AS 1205 but did not identify these deficiencies. Such findings indicate that investor protection could be improved by, among other things, increased involvement in, and evaluation of, the work of other auditors by the lead auditor.

In order to enhance audit practice among all firms using other auditors, the Board has identified the following areas of potential improvement in the current standards:

- *Taking into account recent changes in auditing practice*. Revising PCAOB auditing standards to take into account recent changes that some firms have implemented to improve their auditing practices would serve to make certain improved practices more uniform among accounting firms for audits that involve other auditors. Including these approaches in the auditing standards also would enable the PCAOB to enforce more rigorous provisions for audits that involve other auditors.

- *Applying a risk-based supervisory approach*. Applying a risk-based approach to supervision could result in more appropriate involvement by the lead auditor in supervising the work of other auditors. Unlike the Board's standards for determining the scope of multi-location audit engagements and general supervision of the audit, which require more audit attention to areas of greater risk, the existing standard for using the work of other auditors allows the lead auditor, in certain situations, to limit its involvement to certain specified procedures that are not explicitly required to be tailored for the associated risks. Applying a risk-based approach would direct the lead auditor's supervisory responsibilities to the areas of greatest risk.

- *Providing additional direction*. Providing additional direction to the lead auditor on how to apply the principles-based supervisory requirements under PCAOB standards to supervision of other auditors could help address the unique aspects of supervising other auditors. Additional direction also could help the lead auditor assure that its participation in the