
STANDING ADVISORY GROUP MEETING

RESPONSIBILITIES OF THE PRINCIPAL AUDITOR

APRIL 7- 8, 2010

Introduction

The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is evaluating whether to amend or replace AU sec. 543, *Part of Audit Performed by Other Independent Auditors* ("AU sec. 543") to strengthen certain of its requirements for using the work and reports of other auditors.^{1/}

This briefing paper provides background information on the relevant provisions of AU sec. 543, provisions of analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the AICPA, and issues related to responsibilities of the principal auditor in relation to the work of other auditors. Further, this paper provides information about three discussion topics and related discussion questions: (1) decision to serve as principal auditor, (2) procedures applicable to both methods of reporting, and (3) assuming responsibility for the other auditor's work. Additionally, to facilitate understanding of issues related to the principal auditor's responsibilities, an appendix to this paper includes description of the concept of an audit network.

^{1/} References to AU sections ("AU sec.") throughout this paper are to the PCAOB's interim auditing standards, which consist of generally accepted auditing standards, as described in the American Institute of Certified Public Accountants ("AICPA") Auditing Standards Board's Statement of Auditing Standards No.95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. These standards are available on the PCAOB's web site at www.pcaobus.org.

This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

Background

AU sec. 543

AU sec. 543 was issued in November 1972 and adopted by the PCAOB as one of its interim standards in April 2003. AU sec. 543 provides direction on the professional judgments the auditor makes in deciding (a) whether that auditor may serve as the principal auditor and use the work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented and (b) the form and content of the principal auditor's report in these circumstances.^{2/}

AU sec. 543 explains that the auditor considering whether he or she may serve as principal auditor may have performed all but a relatively minor portion of the work, or significant parts of the audit may have been performed by other auditors. In the latter case, the auditor must decide whether his or her own participation is sufficient to enable the auditor to serve as the principal auditor and to report as such on the financial statements. In deciding this question, the auditor should consider, among other things, the materiality of the portion of the financial statements he or she has audited in comparison with the portion audited by other auditors, the extent of his or her knowledge of the overall financial statements, and the importance of the components he or she audited in relation to the enterprise as a whole.^{3/}

Under AU sec. 543, if the auditor decides that it is appropriate for him or her to serve as the principal auditor, the auditor must then decide whether to make reference in his or her report to the audit performed by another auditor. According to AU sec. 543.06, in some situations, it may be impracticable for the principal auditor to review the other auditor's work or perform other procedures to satisfy himself or herself as to the audit performed by the other auditor. Also, if the financial statements of a component audited by another auditor are material in relation to the total, the principal auditor may decide, regardless of any other considerations, to make reference in his report to the audit of the other auditor.

If the principal auditor decides not to assume responsibility for the work of the other auditor, his or her report should make reference to the audit of the other auditor and should indicate clearly the division of responsibility between himself

^{2/} See AU sec. 543.01.

^{3/} See AU sec. 543.02.

or herself and the other auditor in expressing his or her opinion on the financial statements.^{4/} A small number of reports filed with the Securities and Exchange Commission ("SEC") contain an audit report in which a registered firm makes reference to the audit report of another registered firm.^{5/}

Whether or not the principal auditor decides to make reference to the audit of the other auditor, he or she should make inquiries concerning the other auditor's professional reputation and independence and adopt appropriate measures to assure the coordination of his or her activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.^{6/}

If the principal auditor is able to satisfy himself or herself as to the independence and professional reputation of the other auditor and takes steps he or she considers appropriate to satisfy himself or herself as to the audit performed by the other auditor (according to AU sec. 543.12, the principal auditor must obtain, and review and retain prior to the report release date certain specific information from the other auditor^{7/} and consider performing certain procedures),

^{4/} See AU sec. 543.03.

^{5/} The staff's research indicates that the number of audit reports filed in 2009 containing reference to audits performed by other auditors was – on Forms 10-K and 20-F, respectively – 37 and 22. The total reported market capitalization of these issuers was \$29.5 billion (10-K filers) and \$119 billion (20-F filers.) The five largest issuers in each group had market capitalization of \$22 billion (10-K filers) and \$116 billion (20-F filers.) For the five largest issuers in the 10-K filer group, the share of total assets for which the principal auditor did not accept responsibility ranged from 1% to 6%, and in all five cases, it represented an investment accounted for by the equity method of accounting. For the five largest issuers in the 20-F filer group, the share of total assets and revenues for which the principal auditor did not accept responsibility ranged from 1% to 40%, and 5% to 36%, respectively.

^{6/} See AU sec. 543.10.

^{7/} As amended by PCAOB AS No. 3, paragraph .12 of AU sec. 543 requires that the auditor must obtain, and review and retain, among other things, an engagement completion document, a list of significant fraud risk factors, a schedule of audit adjustments, all significant deficiencies and material weaknesses in internal control over financial reporting, letters of representations from management, and all matters to be communicated to the audit committee.

he or she may be able to express an opinion on the financial statements taken as a whole without making reference in his or her report to the audit of the other auditor. If the principal auditor decides to take this position, he or she should not state in his or her report that part of the audit was made by another auditor.^{8/}

Analogous Standards of IAASB and ASB

The IAASB and ASB have developed standards relating to principal auditor responsibilities. In April 2009, the IAASB published International Standard on Auditing 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* ("ISA 600"), which is effective for periods beginning on or after December 15, 2009. ISA 600 applies to audits of group financial statements that include audits of components^{9/} within the group. Unlike AU sec. 543, ISA 600 does not permit the principal auditor to make reference to other auditors performing part of the audit.

In September 2009, the ASB issued a proposed Statement on Auditing Standards, *Audits of Group Financial Statements (Including the Work of Component Auditors)* ("proposed SAS"). The direction to the auditor in the proposed SAS is generally consistent with ISA 600, except that the proposed SAS permits the auditor's report to make reference to another auditor.^{10/} In the view of the ASB, "there could be considerable practical problems with access issues, particularly with equity investments, under the ISA approach."^{11/}

Issues Related to Responsibilities of the Principal Auditor

Currently, many registered firms routinely enter into arrangements of varying size and complexity with other firms to perform audit procedures ("multi-firm audits") generally to provide services to audit clients that operate in more

^{8/} See AU sec. 543.04.

^{9/} The term *component* is used in ISA 600 to describe an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements (See ISA 600.9(a)).

^{10/} See paragraphs 23-29 of the proposed SAS.

^{11/} See Explanatory Memorandum in the ASB Exposure Draft, Proposed Statement on Auditing Standards, *Audit of Group Financial Statements (Including the Work of Component Auditors)*, dated September 4, 2009.

than one location or country and to grow the firm's business outside of its home country.

In a multi-firm audit, an issuer that has a number of subsidiaries, divisions, branches, or investments (henceforth, "components") located in different countries or regions engages a registered firm, located in most cases near the issuer's headquarters, to issue an audit report on the issuer's consolidated financial statements, i.e., to serve as principal auditor. In order to obtain sufficient appropriate evidence in support of the audit report on the consolidated financial statements, the principal auditor typically uses the work and reports of other auditors, within or outside the principal auditor's network (if the principal auditor is a member of a network), who are located in the same countries or regions as the issuer's components.

In many multi-firm audits the principal auditor assumes responsibility for the entire audit and issues an opinion on the financial statements taken as a whole. However, in some cases, the responsibility for the audit may be divided if the principal auditor decides not to assume responsibility for the entire audit^{12/} and, instead, make reference in its report to the work of another auditor that audited a component of the issuer. In these cases, the other auditor issues a report on and assumes responsibility for the component of the issuer that he or she audited.

In multi-firm audits, the principal auditor typically requires other auditors to (a) perform certain audit procedures in relation to components of the issuer and (b) report results of the procedures performed back to the principal auditor, who then assumes responsibility for the work performed by other auditors. The nature, timing, and extent of the procedures performed at the request of the principal auditor may vary. For example, depending on the size and complexity of the issuer's component, the principal auditor may require another auditor to:

- Prepare an interoffice communication reporting the results of procedures performed on a set of financial statements submitted by the issuer's component to the corporate office for consolidation, or
- Perform an audit of, and issue a report in accordance with PCAOB standards on the stand-alone financial statements of a subsidiary

^{12/} For example, it may be impracticable for the firm that is engaged to audit the consolidated financial statements to review the other auditor's work. See additional discussion of the divided reporting responsibility in section *AU* sec. 543 of this briefing paper.

Information from PCAOB inspections and investigations shows that on some engagements, procedures performed by the principal auditor in relation to the work of other auditors were not sufficient to ensure that the other auditors were qualified to perform the work or that the work performed by other auditors provided the necessary audit evidence. The Board is seeking the SAG's feedback in determining whether to revise AU sec. 543 to strengthen certain requirements of the current standard.

Discussion Topics

Decision to Serve as Principal Auditor

AU sec. 543 requires the auditor to determine if his or her participation is sufficient to serve as the principal auditor when significant parts of the audit are performed by other auditors.^{13/} The standard does not describe when participation is "sufficient." Rather AU sec. 543 states that, in deciding this question, an auditor "should consider," among other things:

[T]he materiality of the portion of the financial statements he has audited in comparison with the portion audited by other auditors, the extent of his knowledge of the overall financial statements, and the importance of the components he audited in relation to the enterprise as a whole.^{14/}

In practice, the level of participation of the principal auditor in audit engagements for which part of the work is performed by another auditor varies. A new standard on responsibilities of the principal auditor could establish more specific criteria (qualitative and/or quantitative) for serving as principal auditor.

Discussion Questions –

1. What criteria should be included in a new standard to describe when an auditor is qualified to serve as principal auditor? Should there be any quantitative criteria, i.e., should a new standard require that the principal auditor obtain audit evidence for a certain minimum percentage of the issuer's revenue or assets? Should the qualitative criteria currently included in AU sec. 543.02 be retained or modified?

^{13/} See AU sec. 543.02.

^{14/} See AU sec. 543.02.

2. In developing the criteria for determining whether an auditor may serve as principal auditor, what, if any, consideration should be given to the firm's affiliation with an audit network?

Procedures Applicable to Both Methods of Reporting

As noted earlier in this paper, under AU sec. 543.10, whether or not the principal auditor decides to make reference to the audit of the other auditor, the principal auditor should make inquiries concerning the professional reputation and independence of the other auditor and adopt appropriate measures to assure the coordination of his or her activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.

AU sec. 543.10 states that the principal auditor's procedures "may include," among other things, ascertaining through communication with the other auditor whether the other auditor is familiar with accounting principles generally accepted in the U.S. ("U.S. GAAP") and that he or she has knowledge of the relevant financial reporting requirements for statements and schedules to be filed with the regulatory agencies such as the SEC. Further, according to AU sec. 543.10, ascertaining the other auditor's knowledge of U.S. GAAP and SEC financial reporting requirements "ordinarily would be unnecessary" if the other auditor's primary place of practice is in the United States.

Qualifications of the other auditor – including the level of technical competence and experience in auditing SEC registrants – may vary significantly between engagements. However, results of the principal auditor's inquiries under the current requirements of AU sec. 543 might not provide sufficient information to evaluate the other auditor's qualifications to, for example, determine the extent of the principal auditor's involvement in the other auditor's work (see additional discussion related to determining the extent of the principal auditor's involvement in the other auditor's work in the next section, *Assuming Responsibility for the Other Auditor's Work*.) A new standard could require obtaining information about the other auditor's professional certifications, relevant experience in auditing SEC registrants, and training records.^{15/}

^{15/} A new standard would necessarily be neutral to any particular accounting framework, because foreign private issuers are allowed, subject to certain conditions, to file with the SEC financial statements that are not prepared under U.S. GAAP.

Discussion Questions –

3. What information about qualifications of the other auditor should a new standard require the principal auditor to obtain? How should the qualifications be evaluated?
4. Should the requirements for obtaining and evaluating the other auditor's qualification be different if both auditors belong to the same audit network? If so, how should they be different?

Assuming Responsibility for the Other Auditor's Work

According to AU sec. 543, the principal auditor may be able to assume responsibility for the work of the other auditor and express an opinion on the financial statements taken as a whole without making reference in his or her report to the audit of the other auditor if the principal auditor is able to satisfy himself or herself as to the independence and professional reputation of the other auditor (discussed in the previous section of this briefing paper) and takes steps he considers appropriate to satisfy himself or herself as to the audit performed by the other auditor.^{16/}

AU sec. 543.05 states that, ordinarily, the principal auditor would be able to assume responsibility for the other auditor's work when:

- The other auditor is "an associated or correspondent firm. . . whose work is acceptable to the principal auditor based on his [or her] knowledge of the professional standards and competence of that firm," or
- The other auditor was retained by the principal auditor and performed work under the principal auditor's guidance and control, or
- The principal auditor, whether or not he or she selected the other auditor, takes steps to satisfy himself or herself as to the other auditor's work, or
- The component audited by the other auditor is not material to the financial statements covered by the principal auditor's opinion.

^{16/} See AU sec. 543.04

AU sec. 543 does not specify how the principal auditor should evaluate the other firm's standards and competence, or what constitutes the principal auditor's "guidance and control."

According to AU sec. 543.12, when the principal auditor decides not to make reference to the audit of the other auditor, the principal auditor must obtain, and review and retain prior to the report release date, certain specific information from the other auditor, including an engagement completion document, a list of significant fraud risk factors, a schedule of audit adjustments, all significant deficiencies and material weaknesses in internal control over financial reporting, letters of representations from management, and all matters to be communicated to the audit committee.

Further, according to AU sec. 543.12, the principal auditor "should consider performing" one or more of the procedures listed in that paragraph, e.g., visiting the other auditor, reviewing the other auditor's audit programs, reviewing additional audit documentation. AU sec. 543 does not specify what factors the principal auditor should consider in determining whether to perform the procedures described in AU sec. 543.12, or in determining the timing and extent of these procedures.

As discussed earlier in this briefing paper, the amount and complexity of work performed by other auditors and used by the principal auditor vary significantly, and the level of competence and experience of the other auditors may vary between the arrangements. Accordingly, a new standard could establish an approach to determining the necessary extent of the principal auditor's involvement in the work of the other auditor, which would be based on (a) the level of risk associated with the other auditor's work (e.g., based on the issuer component's industry, location, volume and complexity of operations, nature of IT environment, risk associated with specific accounts) and (b) the competency of the other auditor. Specifically, in addition to performing certain procedures that would be required in all cases,^{17/} the principal auditor would be required to increase the extent of these procedures or perform additional procedures as the risk associated with an area audited by another auditor increases or as the level of competence of the other auditor decreases.

Further, to determine the extent of the principal auditor's involvement in the work of the other auditor, a new auditing standard could provide direction that is similar to the one in ISA 600. For example, ISA 600 explains the matters that

^{17/} Such procedures would include, for example, the specific review procedures currently required by AU sec. 543.12.

the group engagement team considers when determining the nature, timing and extent of its involvement in the risk assessment procedures and further audit procedures performed by the component auditors on the financial information of the components. In doing so, ISA 600 includes certain provisions from, and includes references to the relevant ISAs.^{18/} A new standard may include certain provisions from and references to the relevant PCAOB standards.

Discussion Questions –

5. What specific direction should a new standard provide to determine the necessary extent of the principal auditor's involvement in the work of the other auditor in order to assume responsibility for the other auditor's work?
6. Would it be appropriate to establish the scope and extent of additional procedures to be performed by the principal auditor in relation to the work of the other auditor based on (a) the risk associated with the area audited by the other auditor, and (b) competency of the other auditor? If not, why not?

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

^{18/} ISA 600 includes references to, for example, ISA 210, *Agreeing the Terms of Audit Engagements*; ISA 220, *Quality Control for an Audit of Financial Statements*; ISA 230, *Audit Documentation*; ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*; ISA 260, *Communication with Those Charged with Governance*; ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*; ISA 300, *Planning an Audit of Financial Statements*; ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*; ISA 320, *Materiality in Planning and Performing an Audit*; ISA 330, *The Auditor's Responses to Assessed Risks*; and ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*.

APPENDIX A

Audit Networks

Appendix

Audit Networks

Currently, most of the registered firms with over 100 audit issuer clients^{1/} are members of an international network of auditing firms. The firms affiliated through audit networks may share the same brand name (e.g., Deloitte, Ernst & Young, KPMG, PricewaterhouseCoopers) or use different names (e.g., Malone & Bailey P.C., a firm that belongs to Nexia International).^{2/}

Audit networks may have one or more member firms per country, in the countries in which the network is represented. Often, in order to market their services to large global companies, network member firms – especially those sharing the same brand name – portray themselves as providing consistent services worldwide or as using consistent audit methodology at all of their member firms.

It is not uncommon for clients of firms in audit networks to have a complex reporting structure that includes a number of subsidiaries, components, equity method investments, joint-ventures, or variable-interest entities. Some components of such a structure (e.g., a recently acquired subsidiary or an equity method investee) may be audited by a non-affiliated firm that has been chosen by the previous owner or appointed in accordance with local laws.

^{1/} As of November 18, 2009, registered firms with over 100 issuer clients, all of which are U.S.-based, included: (a) Firms that belong to an international network – BDO Seidman, LLP; Crowe Horwath LLP; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; KPMG LLP ; Malone & Bailey P.C. (belongs to Nexia International, a worldwide network of independent accounting and consulting firms – see <http://www.nexia.com/>); PricewaterhouseCoopers LLP; McGladrey & Pullen, LLP and (b) A firm that does not belong to an international network – Tait, Weller, & Baker, LLP.

^{2/} The PCAOB requires registered firms to report on Form 2 information about internal and external resources on which the firm draws in performing audits of issuers. As to external resources, Part V of Form 2 requires the firm to identify and describe any memberships or affiliations in or with any network, alliance, or similar arrangement that affords the firm access to resources for use in issuer audits, including procedures, manuals or personnel. (See PCAOB Release No. 2008-004, *Rules on Periodic Reporting by Registered Public Accounting Firms.*)

Appendix

The International Auditing and Assurance Standards Board ("IAASB") defines the term "network" in its International Standard on Quality Control 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* ("ISQC 1"). According to ISQC 1, a network is –

A larger structure: (i) [t]hat is aimed at cooperation, and (ii) [t]hat is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.

An audit network may have an umbrella organization that coordinates admission to the network and deals with various membership matters. A network's umbrella organization is not registered with the PCAOB. Network firms also may form units within the network that perform narrowly defined quality control functions, for example:

- Assign personnel with relevant experience in U.S. GAAP, International Financial Reporting Standards, SEC regulations, and PCAOB standards to the member firms that audit foreign private issuers or the subsidiaries of U.S.-based SEC registrants;
- Monitor certain internal inspections (e.g., inspections of multi-firm audits) conducted at the member firms;
- Monitor compliance by the staff of the member firms with SEC and PCAOB independence requirements.

An audit network may require its member firms to follow its centrally developed policies and procedures.

For the most part, network members describe themselves as separate legal entities. For example, a letterhead of Grant Thornton New South Wales (Australia) includes the following statement, "Grant Thornton Australia Limited is a member firm within Grant Thornton International Ltd. Grant Thornton International Ltd. and the member firms are not a worldwide partnership. Grant Thornton Australia Limited, together with its subsidiaries and related entities, delivers its services independently in Australia."

In another example, the following statement appears in a research report published by Deloitte Touche Tomatsu, "As a Swiss Verein (association), neither

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Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each of the member firms is a separate and independent legal entity operating under the names "Deloitte," "Deloitte & Touche," "Deloitte Touche Tohmatsu," or other related names."^{3/}

Additionally, not all members of an audit network are required to be (and some are not) registered with the PCAOB.^{4/}

^{3/} *Global Financial Services Offshoring Report 2007*. A Deloitte Research Report.

^{4/} According to PCAOB Rule 2100, *Registration Requirements for Public Accounting Firms*, "each public accounting firm that – (a) prepares or issues any audit report with respect to any issuer; or (b) plays a substantial role in the preparation or furnishing of an audit report with respect to any issuer must be registered with the Board."