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## STAFF QUESTIONS AND ANSWERS

### AUDITS OF FINANCIAL STATEMENTS OF NON-ISSUERS PERFORMED PURSUANT TO THE STANDARDS OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

June 30, 2004

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**Summary:** Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers related to PCAOB Auditing Standard No. 1, References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board ("Auditing Standard No. 1"), were prepared by the Office of the Chief Auditor. Questions should be directed to C. Gregory Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org), or Thomas Ray, Deputy Chief Auditor (202/207-9112; rayt@pcaobus.org).

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The Sarbanes-Oxley Act of 2002 (the "Act") directs the Public Company Accounting Oversight Board to establish auditing and related attestation, quality control, ethics and independence standards, to be used by registered public accounting firms in the preparation and issuance of audit reports of issuers.<sup>1/</sup> The Act and PCAOB Rules

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<sup>1/</sup> Section 2(a) of the Act defines "issuer" as "an issuer (as defined in Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under Section 12 of the Act (15 U.S.C. 781), or that is required to file reports under Section 15(d)(15 U.S.C. 780(d)), or that files or has filed a registration statement

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require audits of issuers to be conducted in accordance with PCAOB standards. When issuing an audit report on the financial statements of an issuer, PCAOB Auditing Standard No. 1 requires registered public accounting firms to include a reference to "the standards of the Public Company Accounting Oversight Board (United States)." In contexts other than an audit of the financial statements of an issuer, however, auditors, whether registered or not, may be legally required to, or may agree voluntarily to, perform an engagement in accordance with PCAOB standards or some portion of those standards.<sup>2/</sup> Auditors and other interested persons have raised questions about the implications of Auditing Standard No. 1, as well as the Act and other PCAOB rules, for such engagements. The following staff questions and answers seek to answer some of those questions.

**Q1.** Must a public accounting firm be registered with the PCAOB to perform an audit of a non-issuer according to PCAOB standards?

**A1.** No. The Sarbanes-Oxley Act requires only that those public accounting firms that prepare or issue, or participate in the preparation or issuance of, audit reports on the financial statements of issuers be registered.<sup>3/</sup>

**Q2.** The PCAOB's Auditing Standard No. 1 requires the auditor to include a reference to "the standards of the Public Company Accounting Oversight Board (United States)" in audit reports on the financial statements of issuers. May an auditor refer to "the auditing standards of the Public Company Accounting Oversight Board (United States)" rather

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that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn."

<sup>2/</sup> See, e.g., Securities Exchange Act of 1934 Rule 17i-6(d), 17 CFR 240.17i-6(d) (requiring supervised investment bank holding companies to obtain an audit and review "in accordance with the rules promulgated by the Public Company Accounting Oversight Board").

<sup>3/</sup> The SEC has ordered that broker-dealers that are not issuers need not file with the Commission, and send to their customers, financial statements certified by a registered public accounting firm until January 1, 2005, unless rules are in place regarding Board registration of auditors of such broker-dealers that set an earlier date. See Notice, Broker-Dealer Financial Statement Requirements under Section 17 of the Exchange Act, Rel. No. 34-48281 (August 4, 2003).

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than to "the standards of the Public Company Accounting Oversight Board (United States)" in an audit report on an audit of the financial statements of a non-issuer that was performed in accordance with the Board's auditing standards?

**A2.** Yes. In an audit of the financial statements of a non-issuer, an auditor may wish to be clear that he or she adhered to only the auditing standards of the PCAOB; accordingly, the auditor may include the word "auditing" in the reference to the standards of the PCAOB. Registered public accounting firms, however, are not permitted to limit their reference to the "auditing standards" of the PCAOB in their audit reports on the financial statements of issuers.

**Q3.** What standards are included in a reference to "the standards of the Public Company Accounting Oversight Board (United States)"?

**A3.** A reference to "the standards of the Public Company Accounting Oversight Board (United States)" includes the standards of the Board that are applicable in the circumstances of the engagement. For example, in an audit of financial statements that does not involve the use of a specialist, the auditor would not be expected to follow the Board's interim auditing standard, Statement of Auditing Standards No. 73, "Using the Work of a Specialist." Similarly, in an audit of an entity that has immaterial inventory balances, the auditor would not be expected to follow the Board's interim auditing standard, AU Section 331, "Inventories," of Statement on Auditing Standards No. 1, "Codification of Auditing Standards and Procedures." On the other hand, the Board's interim auditing standard, Statement on Auditing Standards No. 99, "Consideration of Fraud in a Financial Statement Audit," would be applicable in all audits of financial statements conducted pursuant to the Board's standards. As another example, quality control standards generally apply to a firm's system of quality control over its accounting and auditing practice and not to individual audit engagements. Thus, a breakdown in the system of quality control does not necessarily mean that a particular audit was not conducted in accordance with the standards of the PCAOB. However, such a breakdown might result in a deficient audit if it caused or contributed to an audit deficiency. In addition, an auditor who states that he or she has performed the audit in accordance with the standards of the PCAOB must be in compliance with the applicable interim independence standards of the Board. These are examples only, and not an exhaustive list of standards that may be applicable to an engagement. While not required by PCAOB rules, auditors of issuers and other entities subject to the SEC's jurisdiction are

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reminded that they must also comply with applicable Commission requirements, including the Commission's auditor independence requirements.

**Q4.** By referring to "the auditing standards of the Public Company Accounting Oversight Board (United States)" in an audit report on the financial statements of a non-issuer, does the auditor represent that he or she has adhered to the Board's interim independence standards?

**A4.** No. Auditors of the financial statements of non-issuers, including nonprofit organizations, government agencies, municipalities and other governments, should look to relevant state and federal laws and regulations relating to auditor independence. Auditors of nonpublic companies should bear in mind, however, that any company that becomes an issuer, as defined in Section 2(a)(7) of the Act, must file with the SEC an audit report prepared and issued by an independent registered public accounting firm, and therefore it may behoove an auditor of a nonpublic company that intends to become an issuer to comply with SEC and PCAOB independence requirements.

**Q5.** By referring to "the auditing standards of the Public Company Accounting Oversight Board (United States)" or to "the standards of the Public Company Accounting Oversight Board (United States)" in an audit report on the financial statements of a non-issuer, does the auditor represent that he or she has complied with the Commission's auditor independence requirements?

**A5.** No. A Note to the PCAOB's rule on interim independence standards, PCAOB Rule 3600T, reminds auditors of issuers and other entities subject to the SEC's jurisdiction of their separate obligations under the SEC's rule on auditor independence. The PCAOB's rule on interim independence standards does not, however, incorporate the SEC's auditor independence requirements.

**Q6.** What are the PCAOB's independence requirements and to whom do they apply?

**A6.** The PCAOB adopted interim independence standards when it adopted PCAOB Rule 3600T, which is a temporary rule in effect until the Board adopts permanent independence standards. Rule 3600T requires that, when a registered public accounting firm conducts an audit of the financial statements of an issuer, the firm comply with –

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- Rule 101 of the AICPA's Code of Professional Conduct, and interpretations and rulings thereunder, as in existence on April 16, 2003; and
- Standards Nos. 1, 2 and 3, and Interpretations 99-1, 00-1, and 00-2, of the Independence Standards Board.

Registered public accounting firms must also comply with SEC requirements, including its Rule 2-01 of Regulation S-X, relating to auditor independence, when they conduct audits required by the federal securities laws, including audits of financial statements of issuers. The Board did not adopt the SEC's Rule 2-01 because that rule already governs auditor independence from issuers. As a Note to Rule 3600T makes clear, however, in an audit of the financial statements of an issuer, to the extent that a provision of the SEC's rule is more restrictive – or less restrictive – than the Board's interim independence standards, a registered public accounting firm must comply with the more restrictive rule.

**Q7.** Does a reference to "the auditing standards of the Public Company Accounting Oversight Board (United States)" or to "the standards of the Public Company Accounting Oversight Board (United States)" in an auditor's report on the financial statements of a non-issuer imply that the non-issuer is subject to, or otherwise complied with, some or all of the provisions of the Act and other securities laws or the Commission's rules and regulations thereunder?

**A7.** No. An auditor's reference to PCAOB standards in an audit report on the financial statements of a non-issuer does not subject the auditor or the non-issuer to any laws that the auditor or the non-issuer would not otherwise have been required to comply with. Unless the non-issuer is involved in an activity that subjects it to the Act or other securities laws, such as the laws governing broker-dealers, compliance by the auditor or the non-issuer with the Act or other securities laws would be strictly voluntary.

**Q8.** Does inclusion of a reference to the Board's standards in an auditor's report on the financial statements of a non-issuer cause the audit to become eligible for review as a part of a Board inspection?

**A8.** No. An audit of the financial statements of a non-issuer does not become subject to PCAOB inspection solely because the auditor performed and reported

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on the audit in accordance with the standards of the PCAOB. Auditors of the financial statements of non-issuers may, nevertheless, be subject to various forms of state and federal oversight, such as review by federal banking regulators, the U.S. General Accounting Office, or a state board of accountancy.

**Q9.** If a non-issuer elects to have its financial statements audited pursuant to the Board's standards, must it also have its internal control over financial reporting audited pursuant to the Board's Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Conducted in Conjunction with an Audit of Financial Statement"?

**A9.** No. Only certain issuers that are subject to Section 404 of the Act are required to include within the scope of the audit an audit of internal control over financial reporting. Although the Board's standards provide for an integrated audit of financial statements and internal control for those issuers that are subject to Section 404 of the Act, the Board's standards also permit auditors to conduct a financial statement-only audit under circumstances, for example, when Section 404 of the Act is not applicable.

**Q10.** If an auditor refers to either "the standards of the Public Company Accounting Oversight Board (United States)" or "the auditing standards of the Public Company Accounting Oversight Board (United States)" in an audit report on an audit of the financial statements of a non-issuer, is the auditor also required to subject the audit to a "concurring partner review" as required by the Board's adoption of certain of the requirements of the AICPA's former Securities and Exchange Commission Practice Section ("SECPS")?

**A10.** No. The Board may at some time adopt a standard requiring the performance of a second partner review. At this time, however, the PCAOB interim quality control standards only require registered firms that were members of the SECPS as of April 16, 2003, to have a concurring partner review on audits of issuers. (See PCAOB Release No. 2003-006.)