Public Company Accounting Oversight Board; Order Approving Proposed Rules on Auditing Standard No. 7, Engagement Quality Review, and Conforming Amendment

I. Introduction

On August 4, 2009, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission") a notice (the "Notice") of proposed rules (File No. PCAOB-2009-02) on Auditing Standard No. 7, Engagement Quality Review, and Conforming Amendment to the Board’s Interim Quality Control Standards, pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the “Act”). Notice of the proposed rules was published in the Federal Register on November 5, 2009. The Commission received nine comment letters relating to the proposed rules. For the reasons discussed below, the Commission is granting approval of the proposed rules. As specified by the Board, the rules are effective for the engagement quality review ("EQR") of audits and interim reviews for fiscal years beginning on or after December 15, 2009.

II. Description

Section 103 of the Act directs the Board, among other things, to set standards for public company audits, including a requirement for each registered public accounting firm to "provide a concurring or second partner review and approval of [each] audit report (and other related information), and concurring approval in its issuance . . . ." According to the Board, the

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1 See SEC Release No. 34-60903 (October 29, 2009); 74 FR 57357 (November 5, 2009).
proposed rules would strengthen and expand the Board’s existing requirements for concurring reviews.

According to the Board, a well-performed EQR can serve as an important safeguard against erroneous or insufficiently supported audit opinions and, accordingly, can contribute to audit quality. As described in the Notice, the engagement quality review will serve as a meaningful check on the work performed by the engagement team, and the Board believes this should increase the likelihood that a registered public accounting firm will identify any significant engagement deficiencies before it issues its audit report.

Auditing Standard No. 7 requires the engagement quality reviewer (or the "reviewer") to evaluate the significant judgments made and related conclusions reached by the engagement team in forming the overall conclusion on the engagement and in preparing the engagement report. Auditing Standard No. 7 also requires the engagement quality reviewer to perform certain procedures designed to focus the reviewer on those judgments and conclusions. As discussed in the Notice, the procedures required of an engagement quality reviewer are different in nature from the procedures required of the engagement team. Unlike the engagement team, a reviewer does not perform substantive procedures or obtain sufficient evidence to support an opinion on the financial statements or internal control over financial reporting. If more audit work is necessary before the reviewer may provide concurring approval of issuance, the engagement team – not the reviewer – is responsible under PCAOB standards for performing the work. In contrast, the reviewer fulfills the obligation to perform an EQR by holding discussions with the engagement team, reviewing documentation, and determining whether to provide concurring approval of issuance.

The proposed rules also amend the Board's interim quality control standards by replacing the third sentence of paragraph 18 of QC section 20, "System of Quality Control for a CPA
III. Discussion

The Commission received nine comment letters on the proposed rules. Seven letters were received from registered public accounting firms, and two letters were received from professional organizations. The commenters generally agreed with the requirements of Auditing Standard No. 7 and also expressed agreement with the changes made by the PCAOB in response to its comment process.

PCAOB Use and Purpose of Release Text

Many of the comments indicated that there is a lack of clarity resulting from perceived inconsistencies between Auditing Standard No. 7 and text in the Board’s adopting release. One commenter expressed a concern whether the release text has the “same weight” as the standard itself. One commenter expressed a concern that the release text issued with an adopted standard is not subject to the PCAOB’s comment process.


One commenter (CCMC) provided comments related to the PCAOB’s standard-setting process in general, including due process and convergence with international auditing standards. These comments were similar to comments received by the PCAOB during its standard-setting process for Auditing Standard No. 7. In response, the PCAOB stated in its adopting release for Auditing Standard No. 7 that it continuously endeavors to improve its processes, including the standard-setting process, and is considering comments it receives. The Commission encourages the Board to continue to consider comments to improve the Board’s standard-setting process. The Commission will continue to provide oversight as the Board endeavors to improve all of its processes.

See comments of CAQ, CCMC, Deloitte, EY, Grant, KPMG, McGladrey, and PWC.

See comments of PBTK.

See comments of CCMC.
The release text summarizes issues that the Board considered significant in reaching the conclusions set forth in the standard, including responses to comments and the rationale for accepting certain approaches and rejecting others. The Commission publishes notice of and approves the “Rules of the Board” as defined in Section 2(a)(13) of the Act, including the auditing standards adopted by the Board. The release text accompanying the Board’s issuance of an auditing standard is not part of the “Rules of the Board” that are approved by the Commission; rather, it is a statement made by the PCAOB to provide insight into the Board’s decision-making process.

**Documentation of the EQR**

Commenters generally expressed agreement with the documentation requirement as set forth in Auditing Standard No. 7. Many of the same commenters, however, expressed concerns regarding an example in the PCAOB’s adopting release that describes the documentation requirement for significant engagement deficiencies identified by the engagement quality reviewer. The release states that “the EQR documentation should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand, e.g., the significant deficiency identified, how the reviewer communicated the deficiency to the engagement team, why such matter was important, and how the reviewer evaluated the engagement team’s response.”

Commenters were concerned that the example in the release could be read to be inconsistent with the requirement in the standard and could result in unintended consequences in terms of performance. The primary concern was that the engagement quality reviewer may be compelled to document every interaction with the engagement team, not knowing whether a

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7 See comments of CAQ, Deloitte, EY, Grant, KPMG, McGladrey, and PWC.
matter will ultimately be identified as a significant engagement deficiency. Commenters viewed this as a documentation requirement for an EQR that is incremental to the requirements of PCAOB Auditing Standard No. 3, Audit Documentation. Auditing Standard No. 3 does not require the auditor to document each discussion and preliminary conclusion.

In addition, one commenter was concerned that the example provided in the PCAOB’s adopting release may disrupt the communication between the engagement team and the engagement quality reviewer. The commenter expressed a view that, if unable to determine which matters may be significant, the engagement quality reviewer would need to document every issue and therefore would not perform any review procedures until the engagement team completed all audit work and finalized all of its conclusions.

The Commission does not believe that there is any inconsistency between the example in the adopting release and the requirements of Auditing Standard No. 7. The PCAOB specified in its adopting release that the example applies “if a reviewer identified a significant engagement deficiency to be addressed by the engagement team.” We believe that documentation suggested in the example from the adopting release is appropriate after the engagement quality reviewer has concluded that he or she has identified a significant engagement deficiency. However, since several comments were related to this point, we encourage the PCAOB to provide further implementation guidance on the documentation requirement.

Standard of Care

Commenters generally expressed agreement with the revisions that the PCAOB made to the description of due professional care in the standard in response to comments, including

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8 See comments of KPMG.

9 We note clarifications have been provided in other contexts. For example, see PCAOB Staff Q&A at http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2009/09-02_FASB_Codification.pdf
establishing the expected standard of performance by referring to AU Section 230, Due Professional Care in the Performance of Work (“AU 230”).

However, many of the same commenters expressed concern with language in the adopting release about the concept of due professional care. Particularly, many commenters pointed to language in the adopting release that a qualified reviewer who has performed the required review with due professional care “will, necessarily, have discovered any significant engagement deficiencies that could reasonably have been discovered under the circumstances.” Certain commenters expressed a view that the language in the release could be read as requiring absolute assurance or a “flawless” review.

The Commission believes that the PCAOB adequately responded to comments in this area during its reproposal process. We do not find any inconsistency between the PCAOB’s adopting release and the requirement to conduct the EQR with due professional care as described in paragraphs 12 and 17 of Auditing Standard No. 7. Paragraph 12 of Auditing Standard No. 7 references AU 230, which is the source of guidance regarding due professional care in the PCAOB’s interim auditing standards. Moreover, the PCAOB specified in its adopting release that “the Board is not redefining due professional care in the context of the EQR standard.”

Definition of Partner

One commenter suggested that the PCAOB revise the description of the qualifications of the engagement quality reviewer in Auditing Standard No. 7 to specify that equity ownership in the firm is not a requirement for a reviewer. The commenter believed Board language in its adopting release on the distinction between “partner” and “non-partner” could be considered “muddying and potentially biasing (and perhaps unintended) restrictive language.”

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10 See comments of CAQ, Deloitte, EY, Grant, KPMG, and PWC.

11 See comments of Deloitte, Grant, and KPMG.

12 See comments of PBTK.
The discussion of requiring a partner or an individual in an equivalent position to perform the EQR is consistent with the Commission’s independence rules. We do not believe that equity ownership is necessarily inherent in the analysis; rather the analysis of whether an individual is a partner or in an equivalent position is based on the organization of the individual firm and other related facts and circumstances.

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed PCAOB Rules on Auditing Standard No. 7, Engagement Quality Review, and Conforming Amendment (File No. PCAOB-2009-02) are consistent with the requirements of the Act and the securities laws and are necessary or appropriate in the public interest or for the protection of investors.

IT IS THEREFORE ORDERED, pursuant to Section 107 of the Act and Section 19(b)(2) of the Exchange Act, that the proposed PCAOB Rules on Auditing Standard No. 7, Engagement Quality Review, and Conforming Amendment (File No. PCAOB-2009-02) be and hereby are approved.

By the Commission.

Elizabeth M. Murphy
Secretary