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**OBSERVATIONS RELATED TO THE IMPLEMENTATION OF THE AUDITING
STANDARD ON ENGAGEMENT QUALITY REVIEW**

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Executive Summary

This report provides information regarding firms' implementation of, and compliance with, Auditing Standard No. 7, *Engagement Quality Review* ("AS No. 7"), based on 2011 inspections of registered public accounting firms by the Public Company Accounting Oversight Board ("PCAOB" or "Board"). AS No. 7 became effective for audits and interim reviews for fiscal years beginning on or after December 15, 2009.

In 2011, PCAOB Inspections staff conducted inspections of 213 firms and reviewed portions of approximately 820 audit engagements. The inspections identified approximately 310 engagements where the firm, at the time it issued its audit report, had failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements and/or on the effectiveness of internal control over financial reporting ("ICFR"). For 141 of the 213 firms inspected, Inspections staff reviewed the relevant provisions of firms' methodologies and assessed whether the methodologies were consistent with the requirements of AS No. 7. In addition, in some of the engagement reviews, Inspections staff assessed whether deficiencies that it viewed as resulting in an insufficiently supported opinion should have been identified by the engagement quality reviewer before the firm issued its opinion. Inspections staff evaluated that issue for each of the 111 audits performed by seven large domestic firms in which it identified such deficiencies, as well as for a portion of such audits performed by other firms.

Overall Findings

Inspections staff found that, generally, firms' methodologies were consistent with the requirements of AS No. 7. This did not, however, always translate into an appropriately executed engagement quality review. In a number of the engagements, including approximately 39 percent of the 111 audits of seven large domestic firms in which the Inspections staff identified that the audit opinion was insufficiently supported, Inspections staff concluded that the audit deficiency should have been identified by the engagement quality reviewer. For example, Inspections staff noted instances where an engagement quality reviewer reviewed significant judgments made by an engagement team but failed to detect deficiencies in those significant judgments. Observations from the Board's 2012 inspections indicated that audit deficiencies and the related deficiencies in engagement quality reviews continued to be high.

Actions Needed

All registered firms should review this report and consider whether the types of deficiencies that the Board's Inspections staff has observed related to AS No. 7 could manifest themselves in their practices. Firms should be proactive in considering how to prevent these or similar issues, through implementing strong monitoring of the effectiveness of engagement quality reviews, providing robust training and guidance, and holding engagement quality reviewers accountable for their work.

Engagement quality reviewers should take steps to ensure that they have a sufficient understanding of AS No. 7 to be able to complete the required procedures. They should also ensure that they allot to the review the time necessary to complete the procedures appropriately. In carrying out the review, they should ensure that they have obtained a sufficient understanding of the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion.

This report may be useful to audit committees in fulfilling their oversight responsibilities, including by helping to prepare them for meaningful discussions with their auditors about the engagement quality review component of their audit.

This report may also give investors, audit committees, and others the benefit of certain information and analysis concerning certain highlighted audit issues, or the inspection program.

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The engagement quality review is intended to be a review of work already performed by the engagement team. As described in paragraph 2 of the standard,

[t]he objective of the engagement quality reviewer is to perform an evaluation of the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report, if a report is to be issued, in order to determine whether to provide concurring approval of issuance.

The engagement quality review must be performed by a partner or an individual in an equivalent position who must maintain objectivity in performing the review. The reviewer fulfills his or her responsibility to perform an effective review of the engagement under the standard by holding discussions with the engagement team and reviewing documentation. Such procedures form the basis for the reviewer's concurring approval of issuance which, in circumstances in which an engagement report is to be issued, is a pre-requisite to the firm being able to grant permission to the client to use the report. The standard also includes a requirement for the engagement documentation to contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer to comply with the provisions of the standard.

2011 Inspections

In 2011, PCAOB Inspections staff inspected 213 firms, including 42 non-U.S. firms located in 15 jurisdictions. In the course of these inspections, Inspections staff reviewed portions of more than 330 audits performed by ten firms subject to annual inspection in 2011, and portions of more than 485 issuer audits performed by 203 firms subject to inspection at least every three years ("firms inspected triennially"). In approximately 310 engagements, Inspections staff identified that the firm, at the time it issued its audit report, had failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements and/or ICFR.

At 141 firms of the 213 firms inspected, Inspections staff performed specific procedures to evaluate firms' actions taken related to their methodologies and implementation of AS No. 7 during the 2011 inspections cycle. These procedures varied according to the size and nature of the firm's practice, and included inquiring about or reviewing the following related to actions in response to AS No. 7:

- Changes that firms made to their methodologies;
- Materials that firms provided to their staff and partners, including during training;

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- Implementation guidance prepared by firms;
- Firms' implementation tools, such as checklists, programs, and practice aids; and
- Quality control procedures performed pursuant to the implementation of AS No. 7, such as internal monitoring procedures firms performed over engagement quality reviewers' compliance with the requirements of AS No. 7.

In some of the engagement reviews, Inspections staff assessed whether deficiencies that it viewed as resulting in an insufficiently supported opinion should have, in the Inspections staff's view, been identified by the engagement quality reviewer before the firm issued its opinion. Inspections staff evaluated that issue for each of the 111 audits performed by seven large domestic firms in which it identified such deficiencies,^{1/} as well as for a portion of such audits performed by other firms.

Depending on the size and nature of the firm's practice, or based on concerns generated by other procedures, Inspections staff also interviewed some engagement quality reviewers to obtain a more in-depth understanding of the procedures these engagement quality reviewers performed to meet the requirements of AS No. 7.

II. Overall Findings

Inspections staff found that, generally, firms incorporated the requirements of AS No. 7 into their methodologies, introduced checklists, and trained their partners and staff.

The general appropriateness of firms' methodologies, however, did not always translate into an appropriately executed engagement quality review in particular engagements. In any engagement in which a firm issues an insufficiently supported audit opinion, there is reason to consider the possibility that the firm's engagement quality review was deficient. In approximately 39 percent of the 111 such audits identified at the seven large domestic firms mentioned above, as well as in certain of the other audits for which Inspections staff assessed this question, Inspections staff concluded that the audit deficiency occurred in areas that were or should have been reviewed in the engagement quality review process, but that the engagement quality review was deficient. In these engagements, the Inspections staff found that the

^{1/} The seven firms, which are among the firms that the Board inspects annually, are BDO USA, LLP; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; KPMG LLP; McGladrey LLP; and PricewaterhouseCoopers LLP.

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engagement quality reviewers did not evaluate sufficiently the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the report.^{2/}

Examples of deficiencies noted by Inspections staff included:

- The engagement quality reviewer failed to identify that the engagement team had neither designated an audit as higher-risk during the engagement planning nor identified any specific risks associated with the engagement even though the issuer had various risks including, for example, that it was a development stage entity engaged in developing activities in a foreign location.^{3/}
- The engagement quality reviewer failed to identify that the engagement team had not sufficiently planned, reviewed or supervised the audit work performed by a foreign affiliated firm even though audit considerations for multi-location engagements was part of the scope of work reviewed by the engagement quality reviewer.^{4/}
- The engagement quality reviewer identified that additional audit procedures were required to test revenue in response to the risk of material misstatement due to fraud. The engagement quality reviewer, however, did not determine that the additional procedures were performed.^{5/}
- The engagement team identified control deficiencies affecting the same account or disclosure, but failed to evaluate whether, in combination, these deficiencies resulted in material weaknesses. The engagement quality reviewer failed to identify that the engagement team had not made this assessment.^{6/}
- The engagement quality reviewer assessed the audit work performed related to estimates but failed to identify that the engagement team had limited to inquiry its

^{2/} See paragraph 9 of AS No. 7.

^{3/} See paragraph 10(a) of AS No. 7.

^{4/} See paragraphs 10(a) and (b) of AS No. 7.

^{5/} See paragraph 10(b) of AS No. 7.

^{6/} See paragraph 10(c) of AS No. 7.

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testing of the assumptions underlying the issuer's calculation of a significant estimate.^{7/}

The Inspections staff also identified, generally in the firms inspected triennially, examples where:

- The engagement documentation did not contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer.^{8/} For example, the engagement documentation did not indicate what documentation was reviewed by the engagement quality reviewer, others who assisted the reviewer, and the date the engagement quality reviewer provided concurring approval of issuance.
- Firms failed to perform engagement quality reviews of audits, and/or failed to perform engagement quality reviews of interim reviews.^{9/}

III. Potential Root Causes of Non-Compliance with AS No. 7

Inspections staff performed analyses and procedures to identify the potential root causes of the findings relating to firms' implementation of AS No. 7 and performance of engagement quality reviews in accordance with this standard. As a result of this work, Inspections staff identified several factors that may have contributed to the deficiencies related to AS No. 7:

- The engagement completion document did not include all of the information necessary for understanding certain significant findings or issues (or cross-references to available supporting audit documentation). This document, along with any documents cross-referenced should collectively be as specific as necessary in the circumstances for a reviewer to gain a thorough understanding of the significant findings or issues.^{10/} Failing to include the information necessary to understand the findings or issues in the engagement completion

^{7/} See paragraph 10(b) of AS No. 7.

^{8/} See paragraph 19 of AS No. 7.

^{9/} See paragraphs 13 and 18 of AS No. 7.

^{10/} See paragraph 13 of Auditing Standard No. 3, *Audit Documentation*.

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document does not provide the engagement quality reviewer with an opportunity to identify audit deficiencies;

- Engagement quality reviewers over-relied on the engagement team's responses to firm engagement quality review checklists and on discussions with the engagement team, without reviewing the work papers supporting significant judgments made by the engagement team;
- Engagement quality reviewers did not devote sufficient time to the engagement quality reviews, or did not conduct their reviews in a timely fashion, which may have been due to competing priorities. For example, in an audit engagement in which Inspections staff determined that the firm failed to support its audit opinion, the engagement quality reviewer did not review the engagement planning until the fourth quarter, which gave the engagement team less time to alter its planned audit procedures in response to any concerns raised by the engagement quality reviewer; and
- Firms failed to consider known concerns about the quality of work of certain partners who were appointed to perform engagement quality reviews.

IV. 2012 Observations

Inspections staff continued in 2012 and 2013 to evaluate compliance with AS No. 7 in inspections.

Observations from the Board's 2012 inspections indicate that audit deficiencies and related deficiencies in engagement quality reviews continue to be high. Although not every audit deficiency would necessarily be identified and corrected through an engagement quality review, a properly performed engagement quality review should increase the likelihood that a registered public accounting firm will catch any significant engagement deficiencies before it issues its audit report.

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V. Actions Needed

Based on the Inspections staff's analyses of the deficiencies related to AS No. 7, it appears that firms need to consider whether they have assigned the appropriate individuals to perform engagement quality reviews and whether those individuals have a sufficient amount of time to perform the reviews effectively.

Firms should put in place additional measures to help ensure that engagement quality reviews are performed properly and in a timely manner.

Engagement quality reviewers should review this report to be aware of the types of deficiencies that can occur, and should take steps to ensure they have a sufficient understanding of AS No. 7 necessary to complete the required procedures. In carrying out their reviews, engagement quality reviewers should consider whether they have obtained a sufficient understanding of the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and whether they have assigned sufficient time to perform the reviews.

Engagement teams should ensure that they document sufficient information, as required by AS No. 3, for the engagement quality reviewer to gain a thorough understanding of the significant findings or issues.

Firms with audit deficiencies that result in insufficiently supported audit opinions and identified instances of non-compliance with AS No. 7 should analyze their potential root causes and take appropriate actions to prevent these or similar issues from occurring in the future.

All registered firms should review this report and consider whether the types of deficiencies that the Board's Inspections staff has observed related to AS No. 7 could manifest themselves in their practices. Firms should be proactive in considering how to prevent these or similar issues, through implementing strong monitoring of the effectiveness of engagement quality reviews, providing robust training and guidance, and holding engagement quality reviewers accountable for their work.

Audit committees may find this report useful in fulfilling their responsibilities with respect to independent auditors. Audit committees may consider inquiring of the issuer's auditor: (1) how the firm selects, evaluates, and incentivizes its engagement quality reviewer; (2) the qualifications of the engagement quality reviewer, including, for example, his or her years of experience at the firm or years of experience in the issuer's industry; (3) whether the engagement quality reviewer has any history of failing in that role to detect deficiencies that an engagement quality review should detect and that

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were later otherwise detected (such as through a PCAOB inspection, a firm internal inspection, or an issuer's restatement); (4) how the engagement quality reviewer performed his or her review, including the timing and extent of the review; (5) the total hours devoted to the engagement quality review; and (6) the most significant matters identified by the engagement quality reviewer that needed additional audit procedures or follow up.