
STANDING ADVISORY GROUP MEETING

ACCOUNTING FIRMS' AND AUDITORS' RESPONSIBILITY TO SUPERVISE

FEBRUARY 27, 2008

Introduction

At the February 2008 meeting of the Standing Advisory Group ("SAG"), a presentation will be made on the supervision of audit work performed by registered public accounting firms. Following the presentation, SAG members will have an opportunity for additional discussion. Early in the Board's existence, the Board adopted certain standards related to the supervision of audit work and adopted procedural rules providing for possible disciplinary action in the event of a failure reasonably to supervise. At the same time, the Board stated that it would continue to consider whether additional guidance or rulemaking would be appropriate. This paper provides background information about aspects of the Sarbanes-Oxley Act of 2002 (the "Act"), the Board's interim standards, and the Board's rules that relate to supervision. SAG members will be asked to consider whether the current auditing, quality control, and related professional practice standards include sufficient direction concerning supervision of audit work.

Sarbanes-Oxley Act and Supervision

Section 103(a)(2)(b) of the Act provides that the Board shall include, in the quality control standards that it adopts, requirements for every registered public accounting firm relating to, among other things, supervision of audit work. Further, Section 105(c)(6) of the Act provides that the Board may impose sanctions on a registered public accounting firm or on the firm's "supervisory personnel" for failure to reasonably supervise an associated person who violates the Act or certain rules, other laws, or standards subject to the Board's jurisdiction.

<p>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.</p>

The pre-existing standards adopted by the Board as interim auditing standards and interim quality control standards included certain provisions relating to the supervision of audit work. The Board has not, however, formulated supervision standards or rules that go beyond those in the pre-existing standards. In addition, the Board has not adopted rules, standards, or guidance relating to implementation of Section 105(c)(6). The purpose of the SAG discussion is to consider approaches to the regulation of the supervision of audit work through additional rules and standards and through the sanctioning authority in Section 105(c)(6).

PCAOB Interim Standards

Interim Auditing Standards

The Board's interim auditing standards focus on supervision by audit engagement partners of assistants:

Supervision involves directing the efforts of assistants who are involved in accomplishing the objectives of the audit and determining whether those objectives were accomplished. Elements of supervision include instructing assistants, keeping informed of significant problems encountered, reviewing the work performed, and dealing with differences of opinion among firm personnel. The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work.^{1/}

Assistants should be informed of their responsibilities and the objectives of the procedures that they are to perform. They should be informed of matters that may affect the nature, extent, and timing of procedures they are to perform, such as the nature of the entity's business as it relates to their assignments and possible accounting and auditing problems. The auditor with final responsibility for the audit should direct assistants to bring to his attention significant accounting and auditing questions raised during the audit so that he may assess their significance.^{2/}

^{1/} Paragraph .11 of AU sec. 311, *Planning and Supervision*. (References to AU sections ("AU sec.") throughout this paper are to the Board's interim auditing standards, which are available on the PCAOB's Web site at www.pcaobus.org.)

^{2/} Paragraph .AU sec. 311.12.

The Board's interim auditing standards further indicate that the audit partner "is responsible for the assignment of tasks to, and supervision of assistants,"^{3/} and "must exercise a seasoned judgment in the varying degrees of his supervision and review of the work done and judgment exercised by his subordinates...."^{4/} Additionally, the auditing standards state that the "extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work."^{5/}

Interim Quality Control Standards

The Board's interim quality control standards indicate that "[i]n making assignments, the nature and extent of supervision to be provided should be considered. Generally, the more able and experienced the personnel assigned to a particular engagement, the less direct supervision is needed."^{6/} Further, the Board's interim quality control standards indicate that "[t]he quality of a firm's work ultimately depends on the integrity, objectivity, intelligence, competence, experience, and motivation of personnel who perform, supervise, and review the work. Thus, a firm's personnel management policies and procedures factor into maintaining such quality."^{7/}

The Board's interim quality control standards indicate that a firm's personnel management policies and procedures should provide the firm with reasonable assurance that, among other things, "[t]hose hired possess the appropriate characteristics to enable them to perform competently" and "[w]ork is assigned to

^{3/} Paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work*.

^{4/} Paragraph .03 of AU sec. 210, *Training and Proficiency of the Independent Auditor*.

^{5/} Paragraph .AU sec. 311.11.

^{6/} Paragraph .11 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. (References to QC sections ("QC sec.") throughout this paper are to the Board's interim quality control standards, which are available on the PCAOB's Web site at www.pcaobus.org.)

^{7/} Ibid.

personnel having the degree of technical training and proficiency required in the circumstances."^{8/} Additionally, the standards indicate that "[i]n light of the significant responsibilities during the planning and performance of accounting, auditing, and attestation engagements of individuals who are responsible for supervising accounting, auditing, and attestation engagements and signing or authorizing an individual to sign the accountants report on such engagements, a firm's policies and procedures should be designed to provide a firm with reasonable assurance that such individuals possess the kinds of competencies that are appropriate given the circumstances of individual client engagements."^{9/}

Section 105(c)(6) of the Act

Section 105(c)(6) of the Act authorizes the Board to impose disciplinary sanctions on a registered firm or on the "supervisory personnel" of a firm if the firm has failed reasonably to supervise an associated person "either as required by the rules of the Board relating to auditing or quality control standards, or otherwise," and that associated person has committed certain violations. Section 105(c)(6) also provides, that no such sanctions may be imposed if certain conditions have been satisfied concerning the existence of relevant procedures and systems within the firm and concerning the supervising individual's reasonable discharge of relevant duties and obligations. Section 105(c)(6), however, does not prescribe the substance of any supervision that must be provided by a firm or its supervisory personnel, and it does not define the term "supervisory personnel."

In providing for the imposition of sanctions for failure to supervise, the drafters of the Act referred to the similarity between Section 105(c)(6) and provisions of the Securities and Exchange Act that authorize sanctions against broker-dealers for failure to supervise.^{10/} In their present form, however, the Board's supervision-related interim standards differ in some noteworthy respects from the rules that govern supervision in the broker-dealer context. For example, a broker-dealer's supervisory system must provide for "[t]he assignment of each registered person to an appropriately registered

^{8/} Paragraph .02 of QC sec. 40, *The Personnel Management Element of a Firm's System of Quality Control – Competencies Required by a Practitioner-in-Charge of an Attest Engagement*.

^{9/} Paragraph QC sec. 40.03.

^{10/} See S. Rep. No. 205, 107th Cong., 2d Sess. 11, 49 (2002).

representative(s) and/or principal(s) who shall be responsible for supervising that person's activities."^{11/} There is no comparable provision governing the assignment of supervisors in the Board's quality control standards.

Most registered public accounting firms have some form of hierarchical management structure. In a large firm, for example, audit partners may report to another person responsible for the firm's audit practice in a particular region, office, or industry. In a smaller firm, an audit partner might report to a senior partner or managing partner, who may be the firm's founder. But there is no specific direction in the Board's interim standards or rules as to the supervisory responsibilities of firm management personnel.

In addition, the supervision rules applicable to broker-dealers apply both to firms and to their associated persons. In contrast, the Board's quality control standards establish requirements for firms, but not for firm management or other firm personnel. The Board's auditing standards also do not specify supervisory responsibility for any firm personnel other than the auditor with final responsibility for the audit. Also, broker-dealers are required to have written supervisory procedures. There is no such requirement in the Board's quality control standards, although many firms do have written quality control policies and procedures.

To date, the Board has addressed Section 105(c)(6) only by adopting a rule (Rule 5200(a)(2)) that provides for commencing a disciplinary proceeding if it appears that a firm or its supervisory personnel have failed reasonably to supervise an associated person who has committed a violation. When the Board proposed that rule, commenters suggested that the Board should provide guidance concerning the term "supervisory personnel" and the concept of liability for a failure to supervise. One commenter suggested that the Board limit "supervisory personnel" to the partner in charge of an audit and an audit manager, and that the Board spell out what constitutes a failure of reasonable supervision. Some commenters also asserted that supervisory structures of accounting firms are different enough from supervisory structures of broker-dealers that broker-dealer precedent could provide no guidance.

^{11/} NASD Conduct Rule 3010(a)(5). Even the most senior members of a broker-dealer's management are required to have a least one supervisor, *see NASD Provides Guidance on Supervisory Responsibilities*, Notice to Members 99-45 at 296 (June 1999), and each such individual supervisor can be sanctioned for failure reasonably to supervise.

After considering those comments, the Board adopted Rule 5200(a)(2) without providing specific guidance on the scope of supervisory liability under the Act. The Board noted that a firm, as well as individuals, may have supervisory liability, stated that it saw no reason to limit the possibility of such liability only to persons occupying certain positions, and stated that, "even in the absence of additional, specific guidance, investigations may uncover circumstances in which it would be appropriate, under any reasonable reading of the Act, to commence disciplinary proceedings for failure to supervise." However, the Board stated that it would continue to consider whether additional guidance or rulemaking would be appropriate.

Discussion Topics –

The presentation and discussion may address the following topics:

- How the Board should approach the regulation of supervision in a firm's audit practice, including whether to include individuals who are not members of the audit engagement team, such as national office, regional office or quality assurance personnel, within the scope of potential responsibility for supervisory failures.
- The extent to which the existing framework for regulation of supervision by broker-dealers and their associated persons should inform the regulation of supervision by registered public accounting firms and their associated persons.
- Whether current auditing, quality control, and related professional practice standards include sufficient direction concerning supervision of audit work.

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