

# Concept Release

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## Potential Approach to Revisions to PCAOB Quality Control Standards

PCAOB Release No.  
2019-003

Questions  
(202) 591-4395

Publication Date  
December 17, 2019

How to Comment on this Release:

- **By mail:** Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803
- **By email:** [comments@pcaobus.org](mailto:comments@pcaobus.org)
- **Through the PCAOB website:** [www.pcaobus.org](http://www.pcaobus.org).

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**PCAOB**

Public Company Accounting Oversight Board

# Concept Release

## Potential Approach to Revisions to PCAOB Quality Control Standards

PCAOB Release No. 2019-003

Publication Date: December 17, 2019

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## Highlights

The Public Company Accounting Oversight Board (PCAOB or the Board) is seeking public comment on a potential approach to revising the PCAOB's quality control standards. This potential approach is based on the proposed international standard on quality management, ISQM 1, with certain differences as appropriate for firms that are subject to PCAOB standards and rules.

## How to Comment on this Release

To share your views with the PCAOB, please respond to or provide comment on any of the questions and topics included in this release. Responses or comments should be received by the Board no later than March 16, 2020 and refer to PCAOB Rulemaking Docket No. 046 in the subject or reference line. Share your input in any of these ways:

- By mail: Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803
- By email: [comments@pcaobus.org](mailto:comments@pcaobus.org)
- Through the PCAOB website: [www.pcaobus.org](http://www.pcaobus.org).

## Primary PCAOB Standards Affected

<b>QC 20</b>	<i>System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>
<b>QC 30</b>	<i>Monitoring a CPA Firm's Accounting and Auditing Practice</i>
<b>QC 40</b>	<i>The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement</i>
<b>SECPS 1000.08(d)</b>	<i>Continuing Professional Education of Audit Firm Personnel</i>
<b>SECPS 1000.08(l)</b>	<i>Communication by Written Statement to all Professional Personnel of Firm Policies and Procedures on the Recommendation and Approval of Accounting Principles, Present and Potential Client Relationships, and the Types of Services Provided</i>
<b>SECPS 1000.08(m)</b>	<i>Notification of the Commission of Resignations and Dismissals from Audit Engagements for Commission Registrants</i>
<b>SECPS 1000.08(n)</b>	<i>Audit Firm Obligations with Respect to the Policies and Procedures of Correspondent Firms and of Other Members of International Firms or International Associations of Firms</i>
<b>SECPS 1000.08(o)</b>	<i>Policies and Procedures to Comply with Independence Requirements</i>
<b>AS 2901</b>	<i>Consideration of Omitted Procedures After the Report Date</i>
<b>AS 1110</b>	<i>Relationship of Auditing Standards to Quality Control Standards</i>

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## I. INTRODUCTION

*We are considering revising PCAOB quality control (QC) standards to focus firms on improving their QC systems. Effective QC systems are crucial for consistent high quality audits and other engagements under PCAOB standards. We are considering an approach that would be based on the proposed international standard for firms' quality management systems, ISQM 1, with certain modifications.*

Under PCAOB standards, a system of quality control is broadly defined as a process to provide a firm with reasonable assurance that its personnel comply with professional standards applicable to its accounting and auditing practice and the firm's standards of quality. Registered firms are required to design and implement a system of quality control to provide this reasonable assurance.

Our current QC standards were originally developed and issued by the American Institute of Certified Public Accountants (AICPA) before the PCAOB was established. The auditing environment has changed significantly since that time, including evolving and greater use of technology by firms in performing engagements and in relation to QC activities. Some firms have also significantly increased their focus on governance and leadership, incentive systems and accountability, and monitoring and remediation. Current PCAOB QC standards do not reflect these developments.

Our considerations for revising PCAOB QC standards have been informed by a variety of activities. Observations from our oversight activities have shown that firms' improvements in QC systems can enhance the quality of audits, but there is still room for further improvement. Outreach to our advisory groups has indicated general support for strengthening the QC standards, including support for implementing a risk-based approach and for enhancing requirements for firm governance and leadership. We have also considered relevant academic research and literature. We have noted developments and trends in internal control, enterprise risk management, and quality management frameworks, all of which reflect a shift toward more proactive and risk-based approaches, as well as developments relating to corporate governance and audit firm governance.

In addition, the International Auditing and Assurance Standards Board (IAASB) is in the process of updating its analogous firm-level QC standard and recently proposed International Standard on Quality Management 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* (Proposed ISQM 1 or the proposed standard). Proposed ISQM 1 is designed to focus firms' attention on proactively identifying and responding to quality risks that may affect engagement quality. The proposed standard includes specific requirements related to current developments not addressed in PCAOB QC standards.

We are considering using Proposed ISQM 1 as a starting point for a future PCAOB QC standard. Information gathered through our oversight, outreach, and research activities persuades us that our QC standard should be built on an integrated risk-based framework, as Proposed ISQM 1 is. In addition, many firms that follow PCAOB standards are also subject to other QC standards (including the IAASB's and the AICPA's standards), so they are required to implement QC systems that comply with both PCAOB standards and those other standards. Due to the foundational nature of QC systems, we believe that it would not be practical to require firms to comply with fundamentally different QC standards. Unnecessary differences in QC standards could even detract from audit quality by diverting firms' efforts from focusing on matters of fundamental importance to effective QC systems. We understand that the IAASB is in the process of considering comments and making revisions to Proposed ISQM 1. We will continue to monitor the IAASB's work as ISQM 1 is finalized.

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**We are considering using Proposed ISQM 1 as a starting point for a future PCAOB QC standard.**

Although we would seek to avoid unnecessary differences between a future PCAOB QC standard and a finalized international standard, we anticipate that incremental or alternative requirements would be necessary to make our QC standard appropriate for firms performing engagements under PCAOB standards. Different requirements may be needed to:

- a. Align with U.S. federal securities law, Securities and Exchange Commission (SEC) rules, and other PCAOB standards and rules;
- b. Retain important topics in current PCAOB QC standards that are not covered in Proposed ISQM 1, or that are more specific than the requirements in Proposed ISQM 1;
- c. Address specific emerging risks and problems observed through our oversight activities; and
- d. Provide more definitive direction to prompt appropriate implementation of certain requirements by firms that are subject to PCAOB standards and rules.

We believe that any future QC standard the PCAOB may adopt should be scalable, so a firm can tailor its QC system appropriately based on the firm's size and complexity and the nature of the engagements performed, commensurate with applicable risks to quality.

In this concept release, we are seeking comment on an approach to revising PCAOB QC standards. Your comments will help inform our consideration of the approach we might take and what changes we might propose. If we propose a new PCAOB QC standard in the future, you will have the opportunity to comment on our proposal.

We encourage you to read the entire concept release, which includes a discussion of Proposed ISQM 1, potential differences between a future PCAOB QC standard and Proposed ISQM 1, and detailed questions soliciting your feedback on specific aspects of our potential approach. You are encouraged to comment on any or all topics, respond to any or all questions, and provide any evidence (e.g., data or practical experiences) that informs your views.

## Questions



1. Should PCAOB QC standards be revised to address developments in audit practices and provide more definitive direction regarding firm QC systems? Are there other reasons for changes to the QC standards that we should take into account?
2. Is it appropriate to use ISQM 1 as the basis for a future PCAOB QC standard? Are there alternative approaches we should consider?
3. Are the reasons provided for differences between ISQM 1 and a future PCAOB QC standard appropriate? Are there other potential reasons for differences that we should consider?

## II. BACKGROUND AND CONSIDERATIONS FOR POTENTIAL REVISIONS TO QC STANDARDS

### A. Current PCAOB QC Standards

Under PCAOB standards, a QC system is a process to provide a firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality.<sup>1</sup> The QC system encompasses the firm's organizational structure, policies adopted, and procedures established to provide that reasonable assurance.<sup>2</sup>

#### Current PCAOB QC standards identify five elements of the QC system



Current PCAOB QC standards were originally developed and issued by the AICPA and were adopted by the Board on an interim basis in 2003.<sup>3</sup> A list of the individual QC standards can be found in Appendix 1. Our current QC standards consist of:

- General standards that apply to all firms; and
- Certain requirements of membership in the AICPA's SEC Practice Section (SECPS member requirements) that apply only to certain firms.<sup>4</sup> One of the SECPS member requirements, concerning concurring partner review, was superseded in 2009 by the PCAOB's adoption of Auditing Standard No. 7, *Engagement Quality Review* (now AS 1220).

The Sarbanes-Oxley Act of 2002, as amended (Sarbanes-Oxley) authorizes the Board to establish certain professional standards, including quality control standards, to be used by registered public accounting firms in the preparation and issuance of audit reports for audits of issuers, brokers, and dealers.<sup>5</sup>

<sup>1</sup> See QC 20.03.

<sup>2</sup> See QC 20.04.

<sup>3</sup> See PCAOB Rule 3400T, *Interim Quality Control Standards*. See also PCAOB Rel. No. 2003-006, *Establishment of Interim Professional Auditing Standards*. The AICPA has subsequently updated their QC standards.

<sup>4</sup> The SECPS was a division of the AICPA for firms that audited public companies. The SECPS established certain quality control requirements for its members. Those requirements were incorporated into PCAOB rules, applicable only to firms that were SECPS members on April 16, 2003, all of which are U.S. firms. Based on current registration data, the SECPS member requirements apply to 239 (or approximately 13 percent) PCAOB-registered firms, including ten of the twelve 2019 annually inspected firms.

<sup>5</sup> See Sec. 101(c)(2) and 103(a)(1) of Sarbanes-Oxley, 15 U.S.C. 7211(c)(2), 7213(a)(1). This concept release uses the term "issuer" as defined in Sarbanes-Oxley. Under Sarbanes-Oxley Sec. 2(a)(7), an "issuer" means "an issuer (as defined in section 3 of the Securities Exchange Act of 1934), the securities of which are registered under section 12 of that Act, or that is required to file reports under section 15(d), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn." 15 U.S.C. 7201(7) (internal citations omitted).

Sarbanes-Oxley requires the PCAOB's QC standards to address:

- monitoring of professional ethics and independence from issuers, brokers, and dealers on behalf of which the firm issues audit reports;
- consultation within the firm on accounting and auditing questions;
- supervision of audit work;
- hiring, professional development, and advancement of personnel;
- the acceptance and continuation of engagements;
- internal inspection; and
- such other requirements as the Board may prescribe.<sup>6</sup>

## B. Developments Since Adoption of PCAOB QC Standards

Since the PCAOB's current QC standards were first developed and issued by the AICPA, the auditing environment has changed significantly. The current QC standards were developed in the context of the self-regulatory peer review system in place at that time and not with a view to the external regulatory oversight and enforcement environment that has since arisen, including through the establishment of the PCAOB. Nor do the standards consider other key developments affecting audit and assurance practices and QC systems, such as:

- Expanded and evolving use of technology by firms in performing engagements and in relation to QC activities.
- Changes in the management and organizational structure of some firms, including increased variation in practice structures and increased use of transnational firm structures.
- Greater firm use of services and resources supplied by firm networks, affiliates, and third-party service providers. For example, some [global network](#) firms are increasingly imposing on member firms requirements relating to the use of globally developed or acquired methodologies, technology, and policies and procedures established at the global network-level.
- Increased firm use of service delivery centers for firm's QC processes as well as engagement processes.

Additionally, some firms have significantly increased their focus on quality control, especially in areas such as firm governance and leadership, incentive systems, and accountability. Some firms have also augmented their monitoring and remediation processes, including through implementing or enhancing ongoing monitoring activities and internal inspection processes, establishing processes for considering PCAOB inspection findings, performing root cause analysis, and increasing remediation efforts. Observations from our oversight activities have shown that improvements in quality controls can enhance the quality of audits.<sup>7</sup> Not all firms, however, have made such improvements to their QC systems or have done so to the same degree.

There have also been notable advances in internal control, quality management, and audit firm governance.<sup>8</sup>

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<sup>6</sup> See Sec. 103(a)(2)(B) of Sarbanes-Oxley.

<sup>7</sup> See, e.g., [Staff Preview of 2018 Inspection Observations](#) (May 6, 2019), which discussed observations and good practices regarding efforts to improve audit quality, as well as areas of recurring deficiencies.

<sup>8</sup> See, e.g., Committee of Sponsoring Organizations (COSO) *Internal Control-Integrated Framework* (2013), the International Organization for Standardization quality control standard ISO 9000:2015, and the audit firm governance codes of the UK Financial Reporting Council and Japan Financial Services Agency.

Finally, when the current QC standards were first established, they differentiated between firms that were members of the SECPS and those that were not. That distinction was carried forward into the PCAOB's interim QC standards, but we believe it is no longer necessary. A future PCAOB QC standard should be scalable, so a firm can tailor its QC system appropriately based on the firm's size and complexity and the nature of the engagements performed, commensurate with applicable quality risks. Given that the fundamental aspects of a QC system should be the same for all firms, however, we do not see a basis for differentiating in the standard between former SECPS members and other firms. We therefore anticipate that the requirements of a future PCAOB QC standard would apply to all PCAOB-registered firms.

## C. Consideration of Proposed ISQM 1 as the Basis for Revisions to PCAOB QC Standards

We are considering whether and how PCAOB QC standards should be revised to address developments in audit practices and provide more definitive direction<sup>9</sup> regarding firms' QC systems. We are considering an approach based on Proposed ISQM 1 as the starting point for potential revisions to PCAOB QC standards.<sup>10</sup>

Proposed ISQM 1 was issued for comment by the IAASB in February 2019. The comment period ended in July 2019, and we understand that the IAASB is in the process of considering comments and making revisions to the proposal, with a view to voting on a final standard in 2020.<sup>11</sup> We will continue to monitor the IAASB's work as ISQM 1 is finalized, and will continue to consider the need for incremental or alternative requirements in developing a proposal for a future PCAOB QC standard.

Proposed ISQM 1 describes a firm's responsibilities for designing, implementing, and operating a system of quality management for audits or reviews of financial statements, or other assurance or related services engagements.<sup>12</sup> The proposed standard's approach to quality management involves a risk-based approach, which includes requirements for firms to focus on identifying and responding to quality risks.<sup>13</sup> It includes other enhancements intended to improve the robustness of firms' systems of quality management, such as enhanced requirements and focus on governance and leadership and on monitoring and remediation.<sup>14</sup> Proposed ISQM 1 also contains provisions addressing developments affecting audit and assurance practices and QC systems, such as those described in Section II.B. These factors have been important in our consideration of how to approach potential revisions to PCAOB QC standards.

Many firms that we oversee are also subject to other QC standards (including the IAASB's or the AICPA's standards), so they are required to implement QC systems that comply with both PCAOB standards and those other standards. Due to the foundational nature of QC systems, we believe it would not be practical to require firms to comply with fundamentally different QC standards. Unnecessary differences in QC standards could even detract from audit quality by diverting firms' efforts from focusing on matters of fundamental importance to effective QC systems. Several commenters on Proposed ISQM 1 suggested that the IAASB collaborate with other standard setters to promote consistency of requirements to minimize differences that do not benefit audit quality. We understand that the AICPA's Auditing Standards Board (ASB) has established a task force to monitor the IAASB's quality management projects and consider revisions to the AICPA's analogous standards once the IAASB's standards are finalized.<sup>15</sup>

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<sup>9</sup> *I.e.*, more specific instruction on how to satisfy a requirement of the standard.

<sup>10</sup> The IAASB has proposed use of the term "quality management" to replace "quality control." PCAOB standards would continue to use the term "quality control," consistent with Sarbanes-Oxley (Sec. 103(a)(1)), though firms would be free to refer to either quality control or quality management.

<sup>11</sup> See IAASB December 2019 Board Meeting [Agenda Item 7](#) at 1.

<sup>12</sup> See paragraph 1 of Proposed ISQM 1.

<sup>13</sup> See paragraph 10 of Proposed ISQM 1.

<sup>14</sup> See paragraph 7 of the IAASB Explanatory Memorandum accompanying Proposed ISQM 1, at p. 6.

<sup>15</sup> According to the AICPA's [strategic plan](#), the objective of the ASB is to converge its standards with those of the IAASB, while avoiding unnecessary differences between its standards and those of the PCAOB.

We also understand that some global network firms have already begun taking steps to update their QC systems, not only to improve quality, but also in anticipation of the final adoption of ISQM 1.

A risk-based approach to a firm's QC system such as that proposed by the IAASB could:

- Prompt a more proactive and tailored approach to anticipating and responding to quality risks;
- Provide a feedback loop from monitoring activities back to the risk assessment process to support continual improvement in QC systems; and
- Enable firms to scale their QC systems based on the firm's size and complexity and the nature of its engagements.

Outreach to our advisory groups has indicated general support for strengthening the QC standards, including implementing a risk-based approach.<sup>16</sup> Furthermore, a risk-based, proactive approach to QC aligns with our strategic emphasis on prevention of audit deficiencies as a means of improving audit quality.<sup>17</sup>

## Questions



4. Are there other developments affecting audit practices we should consider addressing in a future PCAOB QC standard?
5. To the extent that audit firms are already updating or making enhancements to their QC systems to align with international developments, can you characterize the nature and extent of those changes and related efforts? What benefits do you anticipate from updates to QC systems?
6. Please provide references to any academic studies or data we should consider, including academic studies or data that might address costs and benefits relevant to an economic analysis of potential revisions to PCAOB QC standards.

<sup>16</sup> See, e.g., [Standing Advisory Group \(SAG\) meeting materials and archive](#) for the meeting on June 24-25, 2014.

<sup>17</sup> See PCAOB Strategic Plan 2019-2023 at 8.

## III. POTENTIAL STANDARD-SETTING APPROACH BASED ON PROPOSED ISQM 1

In this section, we provide an overview of Proposed ISQM 1 and potential differences between ISQM 1 and a future PCAOB QC standard.<sup>18</sup>

The IAASB received broad support for the overall risk-based approach of Proposed ISQM 1. Commenters, however, had concerns about scalability, particularly related to the perceived prescriptiveness and overall length of the standard.<sup>19</sup> The IAASB is considering changes to its proposed standard in light of comments received. For example, it is considering changes to the structure of its standard, the firm's risk assessment process, and monitoring and remediation.<sup>20</sup> We will continue to monitor changes made by the IAASB as its standard is finalized, and determine whether incremental or alternative requirements, in addition to those set forth in this concept release, are appropriate.

For the Proposed ISQM 1 Exposure Draft and other related documents, see [the project page on the IAASB's website](#), which includes the following:

- The Exposure Draft;<sup>21</sup>
- Comment letters received; and
- Details from the September 2019 Board meeting.

See also the [IAASB Board Meeting page on the IAASB's website](#) for the relevant December 2019 board materials.

### A. Proposed ISQM 1

Under Proposed ISQM 1, the objective of the system of quality management is to provide the firm with reasonable assurance that:

- a. The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and
- b. Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.<sup>22</sup>

This objective is broadly consistent with the objective in current PCAOB standards, but is more detailed. For example, the objective in Proposed ISQM 1 expressly mentions the firm (not just its personnel), legal and regulatory requirements, and engagement reporting.<sup>23</sup>

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<sup>18</sup> The description of Proposed ISQM 1 in this concept release is based on the February 2019 IAASB Exposure Draft.

<sup>19</sup> See IAASB September 2019 Board Meeting [Agenda Item 4](#) at 1.

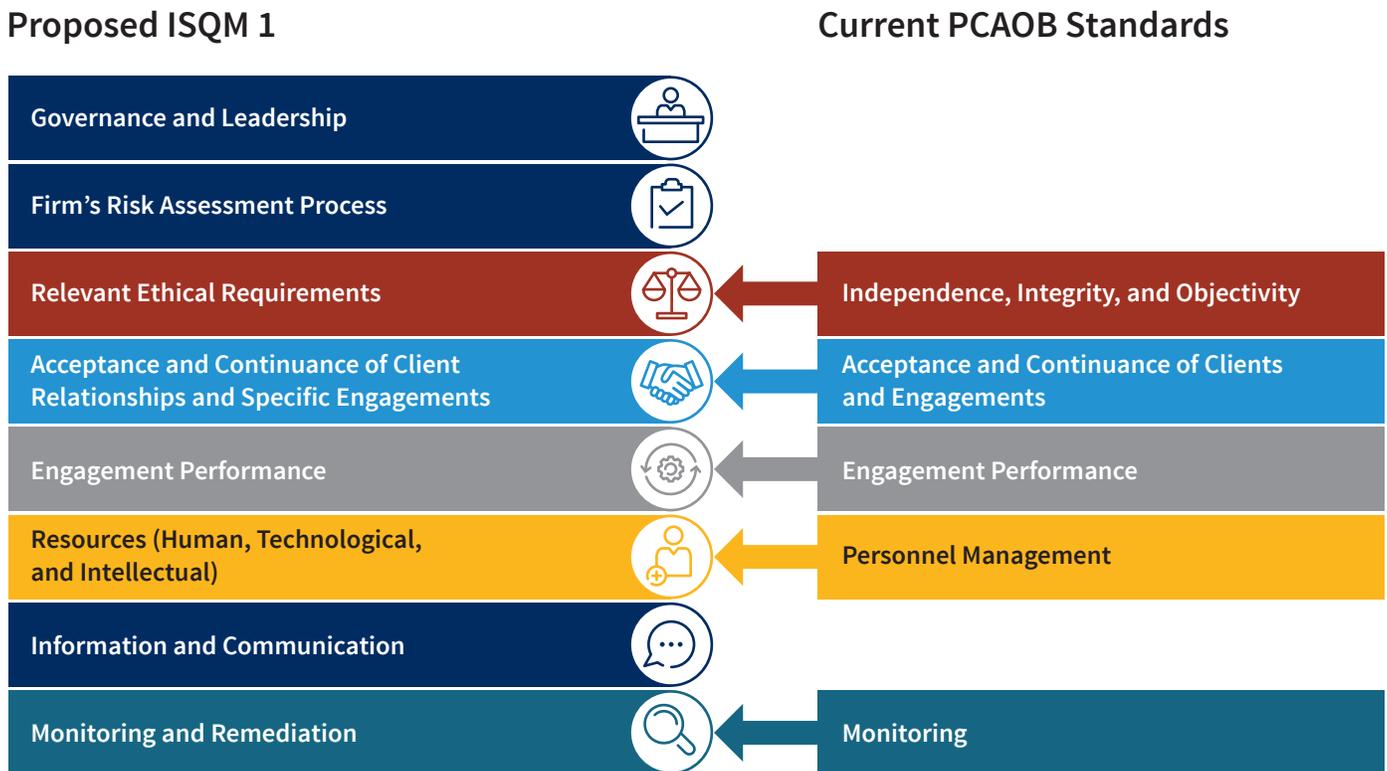
<sup>20</sup> See IAASB December 2019 Board Meeting [Agenda Item 7](#) at 1.

<sup>21</sup> In addition to Proposed ISQM 1, the IAASB also issued Proposed ISQM 2, *Engagement Quality Reviews*, and Proposed ISA 220, *Quality Management for an Audit of Financial Statements*. The Board has previously issued its own standard for engagement quality review, AS 1220. ISA 220 is an engagement level standard, and some of its requirements are included in AS 1201, *Supervision of the Audit Engagement*.

<sup>22</sup> See paragraph 18 of Proposed ISQM 1.

<sup>23</sup> Additionally, the Proposed ISQM 1 definition of "personnel" covers firm partners and staff, while the definition in PCAOB QC standards covers all individuals who perform professional services for which the firm is responsible, whether or not they are CPAs. See QC 20, footnote 4. We are considering how to converge these definitions in a future PCAOB QC standard.

Proposed ISQM 1 describes a firm’s system of quality management as consisting of eight components, which are designed to be highly integrated.<sup>24</sup> The components of Proposed ISQM 1 cover the elements of a QC system under our current standards, in some cases more broadly than our standards currently do. Additionally, Proposed ISQM 1 includes components not currently included in PCAOB standards.



The proposed standard provides that a firm may use different terminology or frameworks to describe the components of its system of quality management.<sup>25</sup>

Proposed ISQM 1 uses an approach that is intended to improve the robustness and effectiveness of a firm’s activities to address engagement quality.<sup>26</sup> The approach of Proposed ISQM 1 “requires a firm to customize the design, implementation and operation of its system of quality management based on the nature and circumstances of the firm and the engagements it performs.”<sup>27</sup> Under this approach, firms would be required to:

- Establish quality objectives;
- Identify and assess risks to the achievement of the firm’s quality objectives (referred to in Proposed ISQM 1 as quality risks); and
- Design and implement responses to address the assessed quality risks.<sup>28</sup>

Proposed ISQM 1 includes certain prescribed quality objectives and prescribed responses for individual components.<sup>29</sup>

<sup>24</sup> See paragraph 8 of Proposed ISQM 1.

<sup>25</sup> See paragraph A5 of Proposed ISQM 1.

<sup>26</sup> See paragraph 9(a) of the IAASB Explanatory Memorandum accompanying Proposed ISQM 1, at p. 7.

<sup>27</sup> See paragraph 8 of the IAASB Explanatory Memorandum accompanying Proposed ISQM 1, at p. 6.

<sup>28</sup> See paragraph 10 of Proposed ISQM 1.

<sup>29</sup> See paragraphs 28 and 38 of the IAASB Explanatory Memorandum accompanying Proposed ISQM 1, at p. 11, and p. 15, respectively.

## B. Potential Differences between ISQM 1 and a Future PCAOB QC Standard

Although we would seek to avoid unnecessary differences between a future PCAOB QC standard and a finalized international standard, we anticipate that incremental or alternative requirements would be necessary for firms performing engagements under PCAOB standards. For example, different requirements may be needed to:

- a. Align with U.S. federal securities law, SEC rules, and other PCAOB standards and rules (e.g., aligning requirements for independence quality controls with PCAOB and SEC independence requirements);
- b. Retain important topics in current PCAOB QC standards that are not covered in Proposed ISQM 1, or that are more specific than the requirements in Proposed ISQM 1 (e.g., PCAOB requirements regarding technical training and professional competencies);
- c. Address specific emerging risks and problems observed through our oversight activities (e.g., requirements regarding the use of other participants in audits); and
- d. Provide more definitive direction to promote appropriate implementation of certain requirements by firms that are subject to PCAOB standards and rules (e.g., provisions regarding roles and responsibilities of individuals concerning the firm's QC system).

In developing a future PCAOB QC standard, the differences from Proposed ISQM 1 may result in incremental or alternative quality objectives or responses, or further quality risk factors for firms to take into account. The "Potential Incremental or Alternative Requirements for PCAOB Standards" section in each component of Section IV describes the differences we are considering. In considering important topics to retain from current PCAOB standards, we are also assessing whether the related requirements need to be updated or refined.

Similar to Proposed ISQM 1, a future PCAOB QC standard could provide that a firm may use a different approach to the design, implementation, and operation of its QC system. The firm's QC system would still be required to meet the reasonable assurance objective and address all the relevant requirements.

We believe that any revisions to the QC standards the PCAOB may adopt should be appropriately scalable, so a firm can tailor its QC system appropriately based on the firm's size and complexity and the nature of the engagements performed, commensurate with applicable quality risks.

This potential standard-setting approach—using Proposed ISQM 1 with incremental or alternative requirements as appropriate—is intended to enable firms to build a single QC system to support engagements under both PCAOB and other applicable standards. The approach would have the advantages of the integrated risk-based framework of the proposed standard, but would also include tailored requirements needed for firms that are subject to PCAOB rules and standards.

## Questions



7. Would the approach to quality control standards described in this concept release be preferable to the current PCAOB quality control standards?
8. Would the objective of a quality management system provided in Proposed ISQM 1 be an appropriate objective for a QC system under PCAOB standards? Are there additional objectives that a quality control system should achieve?
9. Would the potential revisions to PCAOB QC standards described in this concept release improve QC systems and audit quality?
10. Would the potential revisions to PCAOB QC standards described in this concept release enhance firms' ability to prevent audit deficiencies? Are there additional revisions to PCAOB QC standards that we should consider to support a preventive approach to managing quality?
11. Should a future PCAOB QC standard have additional or alternative requirements for firms that audit brokers and dealers? If so, what?

## IV. SPECIFIC ASPECTS OF A QC SYSTEM AND POTENTIAL CHANGES TO PCAOB STANDARDS

This section discusses the individual components of the QC system under Proposed ISQM 1, including for each component:

- Key provisions of Proposed ISQM 1;
- Potential incremental or alternative requirements that we are considering; and
- Information about current PCAOB QC standards.

This section presents certain requirements in the IAASB's February 2019 Exposure Draft of ISQM 1, highlighted in shaded text boxes. Some of the language of the requirements has been edited for presentation, such as eliminating cross-references, condensing introductory language, and replacing the term "system of quality management" with "QC system," the term used throughout this concept release.<sup>30</sup> The text boxes present only the requirements of Proposed ISQM 1 and do not cover the application and other explanatory material.<sup>31</sup>

As noted above, we will continue to monitor the IAASB's actions on this project and assess any further changes that the IAASB decides to make to the standard. This could result in us determining that more (or fewer) incremental or alternative requirements are necessary.

### A. Firm Governance and Leadership

The firm's governance and leadership component establishes the environment in which the QC system operates. This component addresses the firm's culture, decision-making process, actions, organizational structure, and leadership. A firm's culture and tone set by leadership can promote the importance of quality and support the exercise of professional skepticism.

The PCAOB has long considered firm governance and leadership to be a crucial aspect of firms' QC systems. For example, PCAOB inspections have historically covered the firm's tone at the top, a foundational aspect of governance and leadership.<sup>32</sup> SAG members have generally supported including requirements concerning firm governance and leadership in PCAOB QC standards.<sup>33</sup>

## Questions



12. What would be the costs and benefits of implementing and maintaining an integrated QC system as described in this concept release? Are there particular costs and benefits associated with specific components that we should consider? What, if any, unintended consequences would there be?

**The PCAOB has long considered firm governance and leadership to be a crucial aspect of firms' QC systems.**

<sup>30</sup> Footnote 10 explains the use of the term "quality control."

<sup>31</sup> Paragraph A8 of Proposed ISQM 1 states that the application and other explanatory material "does not in itself impose a requirement, [but] it is relevant to the proper application of the requirements." When developing a future PCAOB QC standard, we will consider the extent to which the application and other explanatory material should be addressed in our standard.

<sup>32</sup> See, e.g., *Report on the PCAOB's 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms*, PCAOB Release No. 2008-008 (Dec. 5, 2008) at 6 and Staff Inspection Brief, Vol. 2017/3: Information about 2017 Inspections (Aug. 2017) at 8.

<sup>33</sup> See, e.g., meeting materials and archive for the SAG meeting on Nov. 29, 2018.

## 1. Requirements of Proposed ISQM 1

Under Proposed ISQM 1, a firm would be required to establish the following quality objectives:

- The firm's culture promotes a commitment to quality, including recognizing and reinforcing the importance of professional ethics, values and attitudes throughout the firm and emphasizing the responsibility of all personnel for quality relating to the performance of engagements or activities within the QC system.
- The firm has leadership who is responsible and accountable for quality.
- The firm's strategic decisions and actions, including financial and operational priorities, demonstrate a commitment to quality and to the firm's role in serving the public interest, by consistently performing quality engagements.
- The firm has an organizational structure with appropriate assignment of roles, responsibilities and authority that supports the firm's commitment to quality and the design, implementation and operation of the firm's QC system.
- The firm plans for its resource needs, including financial resources, and obtains, allocates or assigns resources in a manner that supports the firm's commitment to quality and enables the design, implementation and operation of the firm's QC system.
- The firm fulfills its responsibilities in accordance with law, regulation and professional standards that relate to the governance and leadership of the firm, if applicable.

In addition, the proposed standard would require firms to:<sup>34</sup>

- Assign ultimate responsibility and accountability for the QC system to the firm's chief executive officer or the firm's managing partner (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent).
  - o The firm is required to assign an individual who has the appropriate experience and knowledge to fulfill the assigned responsibility.
- Establish policies or procedures for periodic performance evaluations of the individual(s) assigned ultimate responsibility and accountability for the firm's QC system, and the individual(s) assigned operational responsibility for operational responsibilities for the system or aspects of the system, in order to hold individuals accountable for the responsibilities assigned to them.
- Establish policies or procedures for dealing with complaints and allegations about the commitment to quality of the firm or its personnel, including clearly defining channels within the firm that enable reporting by personnel or external parties to appropriate individual(s) without fear of reprisal and enabling the investigation and resolution of the complaints and allegations.

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<sup>34</sup> Section IV. J.2. discusses requirements for the individual assigned ultimate responsibility and accountability for the QC system.

Proposed ISQM 1 would require the assignment of operational responsibilities for the system or aspects of the system to be made to individuals who have:<sup>35</sup>

- The appropriate experience and knowledge and sufficient time to fulfill their assigned responsibility.
- An understanding of their assigned responsibilities and accountability for such responsibilities.

In addition, firms would be required to provide individuals who have operational responsibilities with a direct line of communication to the individual(s) assigned ultimate responsibility and accountability for the QC system.<sup>36</sup>

## 2. Potential Incremental or Alternative Requirements for PCAOB Standards

We are considering incremental requirements concerning three aspects of firm governance and leadership.

First, we are considering an incremental provision that would require firms to make explicit assignments of supervisory responsibilities at successive levels within the firm up to a firm's chief executive officer or equivalent. Such a provision would be intended to promote clarity within a firm about where significant supervisory responsibility rests, potentially avoiding ambiguity that can lead to ineffective supervision and increased risk of violating laws, rules, or standards. The incremental provision would not require firms to develop or adopt a particular supervisory structure for their QC systems. Thus, some firms might already follow practices that would largely satisfy such a provision.

The Board has previously sought public comment on potential standard-setting approaches that, without imposing any new supervisory responsibilities, would require firms to make and document clear assignments of the supervisory responsibilities that are already required to be part of any audit practice.<sup>37</sup> Commenters generally supported the Board's goal of

<sup>35</sup> As noted in Section IV. J.2., making the assignment would be a responsibility of the individual(s) with ultimate responsibility and accountability for the QC system.

<sup>36</sup> See paragraphs 23-25 of Proposed ISQM 1.

<sup>37</sup> See PCAOB Release No. 2010-005, *Application of the "Failure to Supervise" Provision of the Sarbanes-Oxley Act of 2002 and Solicitation of Comment on Rulemaking Concepts* (Aug. 5, 2010). The release and related comment letters can be found in Rulemaking Docket No. 031 on the PCAOB [website](#).

## Questions



13. Is the approach to firm governance and leadership appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
14. Would more clarity in the assignment of firm supervisory responsibilities enhance supervision and positively affect QC systems and audit quality?
15. Should a future PCAOB QC standard address quality considerations in the appointment of a firm's senior leadership? If so, how?
16. Allocation of financial resources is one aspect of firm governance and leadership under Proposed ISQM 1. Should this be given greater emphasis in a future PCAOB QC standard than it is given in Proposed ISQM 1? For example, should a future PCAOB QC standard emphasize the importance of counterbalancing commercial interests that may lead to underinvestment in the audit and assurance practice, particularly in firms that also provide non-audit services?
17. Should a future PCAOB QC standard incorporate mechanisms for independent oversight over firms' QC systems (e.g., boards with independent directors or equivalent)? If so, what criteria should be used to determine whether and which firms should have such independent oversight (e.g., firm size or structure)? What requirements should we consider regarding the qualifications and duties of those providing independent oversight?

providing more clarity relating to the assignment of various supervisory responsibilities within a firm, indicating that additional clarity in this area could have a positive effect on audit quality. Commenters also generally suggested that any changes to the standards be undertaken as part of the QC project.

Second, although the Proposed ISQM 1 mentions financial resources in governance and leadership, we are considering whether a separate, more specific requirement is necessary to direct firms to allocate sufficient financial resources to the audit and assurance practice.

Third, we understand through our oversight activities that some of the largest firms have appointed independent directors or have established equivalent or alternative means of external oversight. Such roles have varying levels of authority, responsibility and influence that may or may not be within the firm's QC system. Some non-U.S. jurisdictions require certain firms to have independent directors.<sup>38</sup> We are considering whether a future PCAOB QC standard should address mechanisms for independent oversight over firms' QC systems (for example, boards with independent directors or equivalent).

### 3. Information about Current PCAOB Standards

Current PCAOB QC standards contain limited references to firm governance and leadership.<sup>39</sup>

#### B. The Firm's Risk Assessment Process

The firm's risk assessment process includes the key building blocks in the risk-based approach to the design, implementation, and operation of the QC system. Thus, it is crucial to an effective, proactive, and integrated QC system.

Potential requirements for firms to identify, assess, and respond to quality risks would prompt firms to take proactive measures to address such risks before they adversely affect the quality of the firm's engagements. Risk assessment, in combination with monitoring and remediation activities (discussed in Section IV.H.), could also serve as a feedback loop to drive continual improvement in QC systems. In a past meeting, SAG members generally supported revising PCAOB QC standards to add requirements for identifying, assessing, and responding to quality risks.<sup>40</sup> In addition, we understand that some firms already employ risk assessment processes in their QC systems, or are implementing them in anticipation of the final adoption of ISQM 1.

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**Risk assessment is crucial to an effective, proactive, and integrated QC system.**

#### 1. Requirements of Proposed ISQM 1

Proposed ISQM 1 would require the firm's risk assessment process to include the following steps:

- **Establish quality objectives.** Proposed ISQM 1 defines quality objectives as those that, when achieved by the firm, collectively provide the firm with reasonable assurance that the objectives of the QC system are

<sup>38</sup> See, e.g., the audit firm governance codes of the UK Financial Reporting Council and Japan Financial Services Agency.

<sup>39</sup> See, e.g., references to the firm's organizational structure in QC 20.04; firm management's philosophy in QC 20.20 and QC 30.02; tone at the top and firm values and culture in the introduction to SECPS member requirements Appendix L, sec.1000.46, *Independence Quality Controls*; and the communications regarding firm management philosophy in SECPS member requirements Sec. 1000.08(l), *Communication by Written Statement to all Professional Personnel of Firm Policies and Procedures on the Recommendation and Approval of Accounting Principles, Present and Potential Client Relationships, and the Types of Services Provided* with the related Appendix H, sec. 1000.42, *Illustrative Statement of Firm Philosophy*.

<sup>40</sup> See meeting materials and archive for the SAG meeting on June 24-25, 2014.

achieved. Proposed ISQM 1 prescribes quality objectives that all firms would be required to establish. The firm would also be required to establish additional quality objectives if necessary to achieve the objective of the QC system.

- **Identify and assess quality risks.** Proposed ISQM 1 would establish a process for identifying quality risks and a requirement to assess the risks identified. The firm would be required to understand the conditions, events, circumstances, actions or inactions that may adversely affect the achievement of its quality objectives, taking into account the nature and circumstances of the firm and its engagements, to provide the basis for the identification and assessment of quality risks.
- **Design and implement responses.** Proposed ISQM 1 would require firms to design and implement responses to address the assessed quality risks in order that the quality objectives are achieved. Proposed ISQM 1 includes some prescribed responses that all firms would be required to design and implement, but indicates that additional responses would be necessary to respond to the assessed quality risks.<sup>41</sup>

We understand that the IAASB is considering changes to its requirements related to the firm's risk assessment process based on comments received, which ranged from concerns that the proposed objectives were overly prescriptive and that prescribed responses appeared disconnected from the risk-based approach, to more general questions as to how the approach would be implemented (including the threshold for risk identification and expectations regarding prescribed responses).<sup>42</sup>

## 2. Potential Incremental or Alternative Requirements for PCAOB Standards

We will continue to monitor the IAASB's activities and consider whether any incremental or alternative requirements are necessary, for instance, to provide clear direction to firms regarding the quality risks that warrant assessment and response. For example, we might specify additional quality risk factors that firms would be required to take into account in identifying and assessing quality risks.

### Questions



18. Is the approach to the firm's risk assessment process appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
19. Are principles-based requirements sufficient to prompt firms to appropriately identify, assess, and respond to risks, or is supplemental direction needed? If supplemental direction is needed, what requirements would assist firms in identifying, assessing, and responding to risks?
20. Should a future PCAOB QC standard specify certain quality risks that must be assessed and responded to by all firms? If so, what should those risks be?
21. Should firms be required to establish quantifiable performance measures for the achievement of quality objectives? If so, how should such measures be determined and quantified (see also Question 46)?

<sup>41</sup> See paragraphs 26-27 and 29-30 of Proposed ISQM 1.

<sup>42</sup> For example, to respond to concerns about scalability, we understand that the IAASB is considering revising the requirements regarding the firm's risk assessment process to add the concept of quality risk factors, which would be used to tailor the process depending on the nature and circumstances of the firm, and its engagements. See IAASB September 2019 Board Meeting [Agenda Item 4](#) at 7-8 and 27-28 and IAASB December 2019 Board Meeting [Agenda Item 7](#) at 6-7.

### 3. Information about Current PCAOB Standards

Under current PCAOB QC standards, firms have a responsibility to establish and maintain a QC system to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality.<sup>43</sup> The current QC standards, however, say little about risk assessment<sup>44</sup> and do not expressly require firms to identify, assess, and respond to quality risks.

## C. Relevant Ethical Requirements

The relevant ethical requirements component addresses the fulfillment of firm and individual responsibilities under relevant ethical requirements, including independence requirements.

### 1. Requirements of Proposed ISQM 1

Under Proposed ISQM 1, a firm would be required to establish the following quality objectives:

- The firm, its personnel and others subject to relevant ethical requirements understand the relevant ethical requirements, including those related to independence.
- The firm, its personnel and others subject to relevant ethical requirements fulfill their responsibilities in relation to the relevant ethical requirements, including those related to independence.
- The firm, its personnel and others subject to relevant ethical requirements identify and appropriately respond to breaches of the relevant ethical requirements, including those related to independence, in a timely manner.

In addition, the proposed standard would require firms to:

- Identify the relevant ethical requirements and determine the applicability of the relevant ethical requirements to the firm, its personnel and others, including, as applicable, the network, network firms, personnel in the network or network firms, or service providers.
- Establish policies or procedures that address the identification and evaluation of threats to compliance with the relevant ethical requirements and how identified threats should be addressed.
- Establish policies or procedures that address the identification, communication, evaluation and reporting of breaches and actions to address the causes and consequences of the breaches.
- Obtain, at least annually, a documented confirmation of compliance with independence requirements from all personnel required by relevant ethical requirements to be independent.<sup>45</sup>

### 2. Potential Incremental or Alternative Requirements for PCAOB Standards

The Proposed ISQM 1 requirements are particularly focused on the *International Code of Ethics for Professional Accountants (including International Independence Standards)* of the International Ethics Standards Board for Accountants. We anticipate that a future PCAOB QC standard would be tailored to the U.S. regulatory environment,

<sup>43</sup> See QC 20.01 and .03.

<sup>44</sup> See e.g., QC 30.05, which cites risks associated with the firm's practice as a consideration in determining the need for and extent of internal inspection procedures in monitoring the firm's QC system. See also QC 20.20.

<sup>45</sup> See paragraphs 32-33 of Proposed ISQM 1.

including existing PCAOB ethics and independence standards and PCAOB and SEC independence rules (which collectively would comprise the relevant ethical requirements in the context of a future PCAOB QC standard).<sup>46</sup>

Examples of differences that we are considering between the Proposed ISQM 1 and a potential future PCAOB QC standard in this area include:

- *Compliance with relevant ethical requirements.* We anticipate that potential requirements would focus on firms establishing policies and procedures<sup>47</sup> to address compliance by the firm and its personnel with the relevant ethical requirements. This includes policies and procedures for its personnel to maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.<sup>48</sup> These alternative requirements would be aligned with the PCAOB ethics and independence standards and PCAOB and SEC independence rules.
- *Retaining key concepts under PCAOB standards.* Current QC standards elaborate on key concepts associated with the ethics standards. For example, QC 20.10 provides that (1) integrity requires personnel to be honest and candid within the constraints of client confidentiality; (2) service and the public trust should not be subordinated to personal gain and advantage; (3) objectivity is a state of mind and a quality that lends value to a firm's services; and (4) the principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. We are considering retaining this elaboration.
- *Independence requirements.* We are considering retaining—with some updates and refinements—the requirements for independence quality controls that currently apply only to former members of the SECPS and extending the requirements to all firms. This is discussed in more detail below.

## Independence requirements

Under current PCAOB standards, firms that were SECPS members as of April 16, 2003, are subject to requirements that address SEC rules regarding independence quality controls. These SECPS member requirements cover a range of topics, including the following:<sup>49</sup>

- Matters relating to the establishment and required contents of firm independence policies and procedures, and related training and requirements for individual professionals.
- Maintaining a database (“Restricted Entity List”) that includes all audit clients that the firm is required to be independent of under SEC rules.
- Reporting by professionals of apparent violations of independence policies involving the professional, their spouse, or dependents, and the corrective action taken or proposed to be taken.
- For firms that audit more than 500 SEC registrants, establishing an automated system to identify investment holdings of partners and managers that might impair independence.
- Designating a senior-level partner responsible for oversight of the firm's independence policies and consultation process; maintenance and dissemination of the Restricted Entity List; and other specified independence-related functions.
- Monitoring compliance with independence policies, including by firm personnel.

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<sup>46</sup> SEC rules regarding auditor independence apply to auditors of issuers and SEC-registered brokers and dealers. See Regulation S-X Rule 2-01.

<sup>47</sup> As in current practice, the procedures required under QC standards may be manual or automated with technology.

<sup>48</sup> See QC 20.09.

<sup>49</sup> See SECPS member requirements Appendix L, sec.1000.46.

The full text of SECPS Section 1000.46, *Appendix L—Independence Quality Controls*, is presented in Appendix 2 to this release.

**Extending QC Requirements to All Firms.** Although the SECPS member requirements currently apply only to firms that were members of the SECPS as of April 16, 2003, the requirements address matters generally relevant to all firms’ compliance with PCAOB and SEC independence rules. In a future PCAOB QC standard, we are therefore considering imposing on all firms the requirements relating to quality control over independence as part of the relevant ethical requirements component.

**Updates and Refinements to the Requirements.** To the extent the SECPS member requirements are incorporated into a future PCAOB QC standard, we would consider updating and refining those requirements. The principal changes we are considering include:

- Revising the requirement for professionals to report apparent independence violations to expressly cover *any* apparent violations affecting the firm’s independence (such as provision of prohibited services), not just personal independence violations. This potential change to the reporting requirement could lead firms to enhance their processes so that important independence-related matters are brought to the attention of appropriate firm personnel, enabling the firm to address them promptly.
- Replacing the references to a “senior-level” partner. Instead of referring to a senior-level partner, we are considering requiring firms to assign responsibility for independence to a qualified individual with appropriate knowledge, skill, ability, capacity, and authority to assume responsibility for independence.<sup>50</sup> This potential change would give firms the flexibility to assign an appropriately qualified individual with the right level of authority in the particular organizational structure of the firm.
- Adding a requirement for firms to expressly address controls over their existing responsibilities for communications with audit committees regarding independence matters. This potential change would address controls over obtaining and communicating complete and accurate information pursuant to PCAOB Rules 3524, 3525, and 3526.<sup>51</sup>

### 3. Information about Current PCAOB Standards

QC 20 provides that policies and procedures should be established to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.<sup>52</sup> The SECPS member requirements regarding independence quality controls apply only to certain firms. The requirements in Proposed ISQM 1, together with the other potential provisions discussed above, are more detailed than the existing requirements in QC 20 and Appendix L of SECPS.

<sup>50</sup> Paragraph 25 of Proposed ISQM 1 is an analogous requirement.

<sup>51</sup> Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*; Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*; and Rule 3526, *Communication with Audit Committees Concerning Independence*.

<sup>52</sup> See QC 20.09.

## Questions



22. Is the approach to relevant ethical requirements appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
23. Should a future PCAOB QC standard extend detailed requirements for independence quality controls (formerly SECPS member requirements) to all firms? How would this affect the costs and benefits of a QC system?

## D. Acceptance and Continuance of Clients and Engagements

The acceptance and continuance component encompasses the firm's processes when considering whether to accept or continue a client relationship or an engagement.

### 1. Requirements of Proposed ISQM 1

Under Proposed ISQM 1, a firm would be required to establish the following quality objectives:<sup>53</sup>

- The firm obtains sufficient appropriate information about the nature and circumstances of the engagement and the integrity and ethical values of the client (including management, and, when appropriate, those charged with governance) and based on such information makes appropriate judgments about whether to accept or continue a client relationship or specific engagement.
- The firm makes appropriate judgments about the firm's ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements when determining whether to accept or continue a client relationship or specific engagement, including that the firm has:
  - o Resources to perform the engagement; and
  - o Access to information to perform the engagement, or to the persons who provide such information.
- The firm's financial and operational priorities do not lead to inappropriate judgments about whether to accept or continue a client relationship or specific engagement.
- The firm responds appropriately<sup>54</sup> in circumstances when the firm becomes aware of information subsequent to accepting or continuing a client relationship or specific engagement that would have caused it to decline the client relationship or specific engagement had that information been known prior to accepting or continuing the client relationship or specific engagement.<sup>55</sup>

### 2. Potential Incremental or Alternative Requirements for PCAOB Standards

We are considering incremental QC requirements to align the above requirements more closely with other PCAOB standards and rules that apply at the engagement level, such as:

- Communications with the predecessor auditor;<sup>56</sup>
- Audit committee pre-approval for services as required by Sarbanes-Oxley and PCAOB rules;<sup>57</sup> and
- Consideration of risks associated with the engagement, to identify matters that could significantly affect the conduct of the engagement and assess whether the firm can develop responses.<sup>58</sup>

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<sup>53</sup> Proposed ISQM 1 also includes a requirement regarding circumstances in which a firm is required by law or regulation to accept an engagement, which is not relevant for engagements under PCAOB standards.

<sup>54</sup> Responding appropriately would not automatically require a firm to withdraw from the engagement or client relationship in all cases. See paragraphs A87-A88 of Proposed ISQM 1.

<sup>55</sup> See paragraph 34 of Proposed ISQM 1.

<sup>56</sup> See generally AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors*.

<sup>57</sup> See, e.g., Sec. 202 of Sarbanes-Oxley, PCAOB Rule 3524 and PCAOB Rule 3525.

<sup>58</sup> See paragraph .41 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

We are also considering retaining the existing requirement for firms to have policies and procedures for obtaining an understanding with the client regarding the services to be performed,<sup>59</sup> updating it as necessary to align with the auditing standards, including AS 1301, *Communications with Audit Committees*.

### 3. Information about Current PCAOB Standards

The requirements of Proposed ISQM 1 and the potential incremental requirements discussed above would not fundamentally change a firm's existing responsibilities regarding acceptance and continuance decisions. The potential requirements would expand on those in QC 20<sup>60</sup> with regard to considering the necessary information and making appropriate judgments about the associated risks and the firm's ability to mitigate those risks and perform the engagement in accordance with professional standards and applicable legal and regulatory requirements. The potential requirements we are considering would also expressly address situations in which the firm becomes aware of relevant contrary information after deciding to accept or continue an engagement.

## E. Engagement Performance

The engagement performance component addresses the firm's processes relating to the work performed by engagement personnel meeting applicable professional standards, legal and regulatory requirements, and the firm's standards of quality.

### 1. Requirements of Proposed ISQM 1

Under Proposed ISQM 1, a firm would be required to establish the following quality objectives:

- Personnel understand and fulfill their responsibilities in connection with the engagement, including, as applicable:
  - The engagement partner's overall responsibility for managing and achieving quality on the engagement and for being sufficiently and appropriately involved throughout the engagement; and
  - The appropriate direction and supervision of the engagement team and review of the work performed.
- Engagement teams exercise appropriate professional judgment and, when applicable to the type of engagement, professional skepticism, in planning and performing engagements such that conclusions reached are appropriate.
- The engagement documentation is appropriately assembled and retained.

In addition, the proposed standard would require firms to:

- Establish policies or procedures addressing the nature, timing and extent of the direction and supervision of engagement teams and review of their work, including that such direction, supervision and review is planned

## Questions



24. Is the approach to acceptance and continuance of clients and engagements appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?

<sup>59</sup> See QC 20.16.

<sup>60</sup> See QC 20.14 -.16.

and performed on the basis that the work performed by less experienced members of the engagement team is directed, supervised and reviewed by more experienced engagement team members.

- Communicate to engagement teams their responsibility for planning and performing the engagement in accordance with professional standards and applicable legal and regulatory requirements.
- Establish policies or procedures addressing consultation on difficult or contentious matters, including the engagement team's responsibilities for consultation, the matters on which consultation is required, and how the conclusions should be agreed and implemented.
- Establish policies or procedures addressing differences of opinion that arise within the engagement team, or between the engagement team and the engagement quality reviewer or personnel performing activities within the firm's QC system, including those who provide consultation.
- Establish policies or procedures addressing engagement quality reviews, and that require an engagement quality review for specified engagements.
- Establish policies or procedures addressing assembly and retention of documentation.<sup>61</sup>

## 2. Potential Incremental or Alternative Requirements for PCAOB Standards

We anticipate that the requirements in a future PCAOB QC standard would align the QC requirements with other PCAOB standards, including for matters such as:

- Supervision;<sup>62</sup>
- Document retention;<sup>63</sup>
- Engagements requiring engagement quality review; and <sup>64</sup>
- The auditor's responsibilities under Section 10A of the Exchange Act, including with respect to fraud, other illegal acts, and going concern consideration.<sup>65</sup>

In addition, we are considering incremental or alternative requirements for the following topics that are covered in current PCAOB QC standards:

- Use of other participants in audits, including other accounting firms and auditor's specialists; and
- Requirements regarding foreign-associated firms that audit issuers (Appendix K Requirements).

Finally, we are considering whether a future PCAOB QC standard should require firms to develop and implement engagement monitoring activities to prompt them to proactively prevent or detect engagement deficiencies, such that appropriate actions can be taken before engagement reports are issued. We understand from our oversight activities that some firms already monitor engagement performance using a variety of techniques, including through

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<sup>61</sup> See paragraphs 36-37 of Proposed ISQM 1.

<sup>62</sup> See, e.g., AS 1201, *Supervision of the Audit Engagement*.

<sup>63</sup> AS 1215, *Audit Documentation*.

<sup>64</sup> AS 1220, *Engagement Quality Review*.

<sup>65</sup> See 15 U.S.C. 78j-1; AS 2401, *Consideration of Fraud in a Financial Statement Audit*; AS 2405, *Illegal Acts by Clients*; and AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*.

establishing and tracking of performance measures, using engagement tracking tools, and performing reviews of in-process engagements. We are considering whether requiring engagement monitoring activities would lead to improvement in engagement performance across all firms. To be scalable, such requirements would need to provide for less formal engagement monitoring activities by smaller, less complex firms, but would also mandate more robust and formal activities for larger, more complex firms.

### Use of Other Participants in Audits

QC 20 addresses quality controls over the use of certain other audit participants in audits as follows:

The system of quality control should provide the firm with reasonable assurance that the segments of the firm's engagements performed by its foreign offices or by its domestic or foreign affiliates or correspondents are performed in accordance with professional standards in the United States when such standards are applicable.<sup>66</sup>

Over the years, the audits of issuers have increasingly involved the use of parties outside the firm in performing audit procedures and evaluating audit evidence. For example, prior PCAOB releases have discussed the increasing prevalence and importance of the use of audit firms and individual accountants outside the firm and the use of auditor's specialists.<sup>67</sup> In addition, we understand that some firms are increasing their use of service delivery centers to perform audit procedures or other tasks on engagements. These centers may be business units of their respective firms or affiliates of one or more firms within the same network.

While it may be beneficial, and in many cases essential, to use other participants in some engagements, these arrangements can pose quality risks because the participants may not be subject to the same quality controls as firm personnel (for example, with regard to personnel assignments, training, supervision, and monitoring).

In addition to retaining the existing requirement in QC 20 described above, we are considering how a future PCAOB QC standard should address quality controls over the firm's use of other audit participants, such as non-affiliated firms, auditor-engaged specialists, and service delivery centers. The prevalence and importance of the use of other audit participants, and the particular quality risks involved, suggest that it may be beneficial for a future PCAOB QC standard to address the use of the broader population of audit participants.

Under the approach we are considering, a future PCAOB QC standard would expressly require firms to have quality controls that address:

- Evaluating the knowledge, skill, and ability of the other participants;
- Evaluating the other participants' independence (if required under the applicable independence rules) or objectivity (if independence is not required);<sup>68</sup>
- Coordination of activities between the firm's engagement personnel and the other participants; and
- Supervision (including review) of the other participants' work.<sup>69</sup>

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<sup>66</sup> See QC 20.06.

<sup>67</sup> See *Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard—Dividing Responsibility for the Audit with Another Accounting Firm*, PCAOB Release No. 2016-002 (Apr. 12, 2016), and *Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*, PCAOB Release No. 2018-006 (Dec. 20, 2018).

<sup>68</sup> For example, PCAOB auditing standards require an assessment of the objectivity of auditor-engaged specialists. See AS 1210, *Using the Work of a Specialist*.

<sup>69</sup> This includes activities to fulfill the responsibilities of the firm and other participants regarding assembly and retention of audit documentation under PCAOB standards.

Under this approach, firms would be required to take into account the relevant requirements of the auditing standards in designing and implementing controls over the above activities.

This approach would prompt firms to make sure that their QC systems address the audit and attestation requirements that would apply to the firms' particular engagements, depending on the type of participant used. For example, current PCAOB auditing standards already address the auditor's responsibilities concerning the use of other auditors and auditor-engaged specialists, and these topics have been the subject of other Board rulemaking activities.<sup>70</sup> Service delivery centers, however, are not addressed as such in existing PCAOB standards. The structure and use of service delivery centers continues to evolve, so we understand that any requirements for their use would need to be principles-based.

Proposed ISQM 1 sets forth requirements for services provided by networks and service providers,<sup>71</sup> which include auditor-engaged specialists. These requirements are potentially relevant to the matters described above and would be taken into account in developing a future PCAOB QC standard.

### Requirements Regarding Foreign Associated Firms that Audit Issuers (Appendix K Requirements)

We are considering whether to retain and update requirements that currently apply with respect to foreign associated firms that audit issuers.

Existing PCAOB standards require SECPS member firms that are associated with international firms or networks to seek adoption (by the international firms or network) of policies and procedures regarding filing reviews,<sup>72</sup> inspection procedures, and disagreements between the engagement partner and the reviewer.<sup>73</sup> The full text of SECPS Section 1000.45, Appendix K—*SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants* is presented in Appendix 3 to this release.

At the time the SECPS issued these requirements, foreign private issuers (FPIs)<sup>74</sup>—a significant segment of foreign-incorporated issuers<sup>75</sup>—were required to reconcile the financial statements they filed with the SEC to U.S. generally accepted accounting principles (U.S. GAAP), if the financial statements were prepared using any basis of accounting other than U.S. GAAP. This reconciliation was an area of focus in the filing reviews by SECPS member firms under Appendix K.

Several years after the Appendix K requirements were issued, the SEC adopted rules that allow FPIs to file financial statements prepared under International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) without reconciliation to U.S. GAAP.<sup>76</sup> Based on data compiled by the PCAOB staff, there were approximately 820 FPI filings with the SEC for fiscal year 2018.<sup>77</sup> About 42 percent of those filings included financial statements prepared under or reconciled to U.S. GAAP, and roughly 90 percent of those financial statements

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<sup>70</sup> See PCAOB Release No. 2016-002 and PCAOB Release No. 2018-006.

<sup>71</sup> See paragraphs 58-65 of Proposed ISQM 1.

<sup>72</sup> The types of SEC filings subject to review are registration statements, annual reports on Form 20-F and Form 10-K, and other filings that include or incorporate the foreign associated firm's audit report on the financial statements of an SEC registrant.

<sup>73</sup> See SECPS member requirements Appendix K, sec. 1000.45; Sec. 1000.08(n).

<sup>74</sup> "Foreign private issuer" is defined in [Rule 405](#) of Regulation C under the Securities Act and [Rule 3b-4](#) under the Exchange Act.

<sup>75</sup> Some other foreign-incorporated issuers that do not meet the FPI definition file with the SEC using domestic forms, and their financial statements are prepared under U.S. GAAP. Appendix K requirements would currently apply if those issuers' financial statements were audited by foreign firms associated with SECPS members.

<sup>76</sup> See SEC, *Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP*, Exchange Act Release No. 57026 (Dec. 21, 2007), 73 FR 986 (Jan. 4, 2008).

<sup>77</sup> Based on a PCAOB staff analysis of SEC filings by FPIs that contained audited financial statements through May 24, 2019.

were audited by non-U.S. firms affiliated with global networks (so the audits of those financial statements are already subject to Appendix K requirements). Fewer than 90 FPI filings were audited by non-U.S. firms not affiliated with global networks.

*Potential Updates to the Requirements.* We are evaluating whether the Appendix K requirements remain relevant. For example, retaining the requirement for a review of the filing by a person<sup>78</sup> knowledgeable in applicable accounting, auditing, independence requirements, and SEC rules and regulations would help address the risk that a non-U.S. firm lacked sufficient technical proficiency in those areas. This might particularly be the case for firms with limited experience with PCAOB standards and SEC rules, and firms in jurisdictions that primarily apply home country accounting principles or modified IFRS.

We seek comment regarding whether changes to the scope and application of the Appendix K requirements would be appropriate. For example, we are seeking comment on whether (1) Appendix K requirements should be extended to all audits in which a non-U.S. firm issues an audit report on the financial statements of an issuer, and (2) certain types of audits (such as audits of financial statements presented under IFRS as issued by the IASB) should be exempt from all or a portion of the Appendix K requirements. Also, we seek comment on whether the Appendix K requirements for inspection procedures and disagreements should be updated to align with the potential requirements that we are considering for monitoring and remediation and differences of opinion.

### 3. Information about Current PCAOB Standards

QC 20 contains general requirements regarding engagement performance, including planning, performing, supervising, reviewing, documenting, communicating the results of each engagement, referring to authoritative literature, and consulting with qualified individuals when appropriate. The requirements in Proposed ISQM 1 together with the other potential revisions discussed above are more expansive and detailed than the existing requirements in QC 20.

<sup>78</sup> We anticipate that the filing reviewer could be either employed or engaged by the firm, as long as the person has the required technical proficiency.

## Questions



25. Is the approach to engagement performance appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
26. Should a future PCAOB QC standard expressly address firm responsibilities and actions to support and monitor the appropriate application of professional skepticism and significant judgments made by engagement teams? If so, how?
27. Should a future PCAOB QC standard expressly address the use of other audit participants? If so, should the scope of the requirements include affiliated and non-affiliated entities and individuals, including specialists and service delivery centers? Should we consider any changes to the scope of the potential requirements described? If so, what changes would be necessary?
28. Should the Appendix K requirements be retained? Should the scope or application of the Appendix K requirements be changed, for example to extend the requirements to all audits in which a non-U.S. firm issues an audit report on the financial statements of an issuer, or to exempt certain audits from one or more requirements? Should the individual requirements in Appendix K for filing reviews, inspection procedures, or disagreements be revised or updated? If so, how? Is it clear how the responsibilities of an Appendix K reviewer differ from the role of the engagement quality reviewer?
29. Should a future PCAOB QC standard require firms to adopt engagement monitoring activities (e.g., performance measures, engagement tracking tools, or reviews of in-process engagements) that would prompt them to proactively prevent or detect engagement deficiencies? What are examples of less formal, but effective, engagement monitoring activities that could be adopted by smaller firms?
30. How should a future PCAOB QC standard expressly address firms' actions to support the fulfillment of the auditor's responsibilities under Section 10A of the Exchange Act, including:
  - a. With respect to fraud?
  - b. With respect to other illegal acts?
  - c. With respect to going concern consideration?

## F. Resources

The resources component of Proposed ISQM 1 addresses the firm's responsibilities for appropriately obtaining, developing, using, maintaining, allocating, and assigning resources—including human resources, technological resources, and intellectual resources<sup>79</sup>—in a timely manner to enable the design, implementation, and operation of the QC system.

### 1. Requirements of Proposed ISQM 1

Under Proposed ISQM 1, a firm would be required to establish the following quality objectives:

- The firm hires, develops and retains personnel, including engagement partners, who have the competence and capabilities to:
  - o Consistently perform quality engagements, including knowledge or experience regarding professional standards and applicable law or regulation relevant to the engagements the firm performs; or
  - o Perform activities or carry out responsibilities in relation to the operation of the firm's QC system.
- The firm assigns an engagement partner and other human resources to each engagement who have appropriate competence and capabilities, including being given sufficient time, to consistently perform quality engagements.
- The firm assigns human resources to perform activities within the QC system who have appropriate competence and capabilities, including sufficient time, to perform such activities.
- Personnel demonstrate a commitment to quality through their actions and behaviors, develop and maintain the appropriate competence to perform their roles, and are held accountable through timely evaluations, compensation, promotion and other incentives.
- The firm obtains or develops, implements and maintains appropriate technological resources to enable the operation of the firm's QC system management and the performance of engagements.
- The firm obtains or develops, implements and maintains appropriate intellectual resources to enable the consistent performance of quality engagements, and such intellectual resources are consistent with professional standards and applicable legal and regulatory requirements, where applicable.
- Personnel appropriately use the firm's technological and intellectual resources.<sup>80</sup>

### 2. Potential Incremental or Alternative Requirements for PCAOB Standards

The Proposed ISQM 1 requirements broaden the resource component beyond human resources to include a specific focus on technology, given the importance of transformational technologies and advanced data analysis capabilities. With respect to technological resources, we are considering an incremental provision that would expressly require firms to design and implement controls to prevent unauthorized access to technology and related data used on

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<sup>79</sup> Intellectual resources generally include information a firm uses to promote consistency in the performance of engagements, including, for example, a firm's written policies or procedures, methodologies, guides, practice aids, standardized documentation, and access to information sources. Intellectual resources may be internally developed, provided by a firm's network, or purchased from an external service provider.

<sup>80</sup> See paragraph 38 of Proposed ISQM 1.

engagements or in the operation of the QC system. These controls are important to maintain the integrity of engagement and QC automated processes and related data.

In addition, Proposed ISQM 1 addresses a firm's responsibilities with respect to its use of resources or services provided by firm networks and service providers.<sup>81</sup> We anticipate that a future PCAOB QC standard would address a firm's responsibilities for evaluating the appropriateness of those services and resources, supplementing or adapting them as necessary to comply with PCAOB standards and applicable legal and regulatory requirements, and in light of the nature and circumstances of the firm and its engagements.

In addition, we are considering retaining, with revision, certain existing requirements related to technical training and professional competencies, as discussed below.

### Technical Training

QC 20 provides that policies and procedures should be established to provide the firm with reasonable assurance that, among other things, personnel participate in continuing professional education (CPE) and other professional development activities that enable them to fulfill responsibilities assigned and satisfy applicable CPE requirements.<sup>82</sup> In addition, SECPS member requirements provide that member firms should ensure that (1) all professionals in the firm residing in the United States, including CPAs and non-CPAs, participate in at least 20 hours of qualifying CPE every year and at least 120 hours every three years and (2) professionals who devote at least 25 percent of their time to performing audit, review or other attest engagements, or who have the partner- or manager-level responsibility for the overall supervision or review of any such engagements, must obtain at least 40 percent (eight hours in any one year and 48 hours every three years) of their required CPE in subjects relating to accounting and auditing.<sup>83</sup> The member requirements also address measurement and documentation of compliance with the requirements.<sup>84</sup> In addition, member firms are specifically required to establish a training program on independence.<sup>85</sup>

Observations from oversight activities have identified instances in which some engagement team members did not receive periodic training on PCAOB standards and SEC requirements, or the training was not effective, such that in some cases their lack of understanding of PCAOB standards may have contributed to audit deficiencies. These problems have been observed in domestic firms and international firms, including firms that were not SECPS members.

Because of the importance of regular effective technical training, we are considering incremental requirements to provide additional direction regarding such training. Specifically, we are considering requiring firms to provide training to firm personnel sufficient to maintain qualified staff and enable personnel to fulfill their assigned engagement and QC roles with competence. The nature and timing of the training would be based on the relevant quality risks, and may include, for example, industry-specific training to address unique considerations of audits in particular industries. At a minimum, instead of requiring training in "subjects related to accounting and auditing,"

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<sup>81</sup> See paragraphs 58-65 of Proposed ISQM 1.

<sup>82</sup> See QC 20.13. See also QC 40.

<sup>83</sup> See SECPS member requirements Sec. 1000.08(d), *Continuing Professional Education of Audit Firm Personnel*, and SECPS member requirements Sec. 8000, *Continuing Professional Education Requirements Effective for Educational Years Beginning After May 31, 2002*. The SECPS member requirements provide that the term "accounting and auditing subjects" should be broadly interpreted, and include, for example, subjects relating to the business or economic environments of the entities to which the professional is assigned.

<sup>84</sup> See generally SECPS member requirements Sec. 1000.08(d) and SECPS member requirements Sec. 8000.

<sup>85</sup> See SECPS member requirements Appendix L, sec.1000.46.

firms would be required to provide training at least annually on professional standards<sup>86</sup> and SEC requirements for all firm personnel who (1) participate in engagements under PCAOB standards or (2) are assigned to QC roles that relate to compliance with professional standards and SEC requirements. The need for regular training applies to all firms, so we anticipate that these potential requirements would also apply to all firms, including firms that were not SECPS members.

## Professional Competencies

In addition, we are considering retaining and updating certain existing requirements regarding engagement partner competencies, and extending them to cover others in engagement and QC roles.<sup>87</sup> Currently, QC 40 addresses QC requirements regarding the competency of engagement partners.<sup>88</sup> Among other things, the standard provides that firms' QC policies and procedures should ordinarily address the following competencies of the engagement partner and other competencies as necessary in the circumstances:<sup>89</sup>

- An understanding of:
  - o The role of the firm's QC system;
  - o The performance, supervision, and reporting aspects of the engagement, normally gained through actual participation in that kind of engagement under appropriate supervision;
  - o The applicable professional standards, including those standards directly related to the industry in which a client operates and the kinds of transactions in which a client engages;
  - o The industry in which a client operates, including an understanding of the industry's organization and operating characteristics sufficient to identify areas of high or unusual risk associated with an engagement and to evaluate the reasonableness of industry specific estimates; and
  - o How the organization is dependent on or enabled by information technologies, and the manner in which information systems are used to record and maintain financial information.
- Sound professional judgment, including the ability to exercise professional skepticism and identify areas requiring special consideration such as, the evaluation of the reasonableness of estimates and representations made by management and the determination of the kind of report necessary in the circumstances.

We are considering updating the list of competencies in a future PCAOB QC standard by:

- Expanding the required knowledge of professional standards to specifically include knowledge of applicable PCAOB rules and SEC requirements relevant to the engagement.
- Adding an understanding of the relevant internal control framework used by the company.<sup>90</sup>

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<sup>86</sup> See PCAOB Rule 1001 (p)(vi) for a definition of "professional standards," which covers, among other things, both accounting and auditing.

<sup>87</sup> Current PCAOB standards address required attributes of an engagement quality reviewer. See AS 1220.05, which provides that the engagement quality reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.

<sup>88</sup> This concept release uses "engagement partner" instead of the term "practitioner-in-charge to be qualified to perform an accounting, auditing, or attestation engagement" as used in QC 40.

<sup>89</sup> See QC 40.08. Certain provisions in QC 40.08 are qualified to refer to audits and reviews of financial statements. We anticipate that, if we update these provisions, they would be applied to all engagements under PCAOB standards.

<sup>90</sup> See AS 2110.22 and paragraph .05 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

- Adding an understanding of technology used in obtaining or evaluating audit evidence, given the increasing importance and evolving nature of the use of technology in performing audits. (This would require the engagement partner to have a sufficient understanding of the relevant technology, including the use of firm-approved technology, to be able to design and perform audit procedures and evaluate audit results in accordance with PCAOB standards.)
- Expressly including objectivity in the description of sound judgment, to prompt firms and their engagement partners to remain aware of and avoid biases that may impair sound judgment.
- Expressly including, for attestation engagements, technical proficiency in attestation engagements and knowledge of the subject matter of the assertion on which the engagement is based.<sup>91</sup>
- Expressly addressing whether the individual is licensed to practice public accounting in the relevant jurisdiction.

The required competencies of engagement partners also apply, by extension, to engagement quality reviewers.<sup>92</sup> We are considering whether the standards should also address competencies of other personnel in engagement roles. We could, for example, indicate that the listed types of competencies for the engagement partner also apply to others participating in the audit to varying degrees, based on their assigned work. For example, engagement personnel involved in performing or supervising tests of controls would need, among other things, an understanding of professional standards, the internal control framework, and the relevant industry in which the company operates.

Similarly, we are considering the extent to which a future PCAOB QC standard should address the competencies of firm personnel in QC roles. Although QC roles vary widely, appropriate competencies may be particularly important to some roles. For example, personnel performing internal inspections would need competencies similar to those participating in audits, those performing consultations would need sufficient knowledge of the subject matter and

<sup>91</sup> See paragraphs .20-.21 of AT 101, *Attest Engagements*.

<sup>92</sup> See AS 1220.05.

## Questions



31. Is the approach to resources appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
32. Should a future PCAOB QC standard continue to expressly address technical training on professional standards and SEC requirements? Are there other subjects for which training should be expressly required? Which firm personnel should be covered by the training requirements? Should the standards set minimum requirements for the extent of training? If so, what should those requirements be based on?
33. Should a future PCAOB QC standard continue to expressly address required competencies of engagement partners? Are the competencies discussed in this concept release appropriate? Are there other competencies that should be added?
34. Should the competencies of individuals in engagement or QC roles, in addition to the engagement partner and engagement quality reviewer, be addressed in a future PCAOB QC standard?
35. Should a future PCAOB QC standard expressly address the use of emerging technology in QC systems or engagements? Should a future PCAOB QC standard expressly require firms to design and implement controls to prevent unauthorized access to technology and data? Are there any other requirements we should consider related to the use of technology on engagements?
36. Ensuring that firm personnel in QC and engagement roles have sufficient time to properly carry out their responsibilities is one aspect of firm resources under Proposed ISQM 1. Should a future PCAOB QC standard place greater emphasis on this requirement than Proposed ISQM 1 does? If so, how?
37. Should a future PCAOB QC standard expressly address how the firm's incentive system, including compensation, incorporates quality considerations? If so, how?

related requirements to provide appropriate advice, and those responsible for the independence function would need appropriate knowledge of the PCAOB and SEC independence requirements.

### 3. Information about Current PCAOB Standards

The Proposed ISQM 1 requirements largely cover the same requirements as the QC 20 requirements for personnel management and assignment of responsibilities.<sup>93</sup> The remaining requirements of Proposed ISQM 1 and the other potential revisions discussed above regarding resources are more expansive than the existing requirements in current PCAOB QC standards.

## G. Information and Communication

The information and communication component addresses the firm's responsibilities for obtaining, generating, and using information regarding the QC system, as well as communicating information within the firm and to external parties on a timely basis to enable the design, implementation, and operation of the QC system.

### 1. Requirements of Proposed ISQM 1

Under Proposed ISQM 1, a firm would be required to establish the following quality objectives:

- The firm has an information system that supports the QC system by identifying, capturing, processing and maintaining relevant and reliable information, whether from internal or external sources.
- The firm communicates relevant and reliable information to personnel, the nature, timing and extent of which is sufficient to enable personnel to understand and carry out their responsibilities relating to the performance of engagements or activities within the QC system.
- The firm's culture promotes and emphasizes the responsibility of personnel to exchange information with the firm and with one another.
- Personnel communicate relevant and reliable information to the firm when performing engagements or activities within the QC system.
- The firm communicates relevant and reliable information to external parties regarding the firm's QC system, as the firm determines appropriate.

In addition, the proposed standard would require firms to:

- Establish policies or procedures that address the nature, timing and extent of communication and matters to be communicated by the firm with engagement teams.
- Communicate the responsibility for implementing the firm's responses to relevant personnel, including engagement teams.
- Establish policies or procedures that address the nature, timing and extent of communication and matters to be communicated with external parties, including:
  - o Communication to external parties in accordance with law, regulation or professional standards.

<sup>93</sup> See QC 20.13 and .22. See also QC 40.

- o Communication with the network.
- o Communication with service providers.
- o Other communication to external parties about the firm’s QC system, in a transparency report or otherwise, when the firm determines it appropriate to do so, taking into account:
  - Whether there are external parties who may use such information to support their understanding of the quality of the engagements performed by the firm; and
  - The nature and circumstances of the firm, including the nature of the firm’s operating environment.<sup>94</sup>

## 2. Potential Incremental or Alternative Requirements for PCAOB Standards

We anticipate that a future PCAOB QC standard would include requirements that expressly address required communications by the firm or engagement teams to audit committees, the SEC, the PCAOB, or otherwise as required by law, regulation, and PCAOB standards and rules (for example, communications under Section 10A of the Exchange Act, AS 1301, Form AP, or Form 2, or in conjunction with company listing requirements<sup>95</sup>).

In addition, Section IV.H.2. of this release discusses potential incremental requirements regarding external reporting by firms, including possible reporting, on the effectiveness of a firm’s QC system.

## 3. Information about Current PCAOB Standards

The Proposed ISQM 1, together with the potential requirements discussed above, would more broadly address the firm’s responsibilities regarding its information system and internal and external communications. Existing PCAOB QC standards focus principally on communication of certain information, specifically:

- Firm QC policies and procedures;<sup>96</sup>
- Weaknesses identified in the QC system or the level of understanding or compliance therewith;<sup>97</sup>
- Internal inspection findings;<sup>98</sup>
- Principles that influence the firm’s policies and procedures on matters related to the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided;<sup>99</sup>

### Questions



38. Is the approach to information and communication appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
39. Should a future PCAOB QC standard require public disclosure by firms about their QC systems? If so, what should be the nature and timing of such disclosures (e.g., information about the firm’s governance structure)? (see also Question 46)

<sup>94</sup> See paragraphs 40-41 of Proposed ISQM 1.

<sup>95</sup> See, e.g., NYSE Listed Company Manual Section 303A.07(b)(iii)(A).

<sup>96</sup> See QC 20.23.

<sup>97</sup> See QC 30.03.

<sup>98</sup> See QC 30.06.

<sup>99</sup> SECPS member requirements Sec. 1000.08(l) and Appendix H, sec. 1000.42.

- Additions to the Restricted Entity List; and <sup>100</sup>
- Notification to the SEC of resignations and dismissals from audit engagements for commission registrants.<sup>101</sup>

## H. The Monitoring and Remediation Process

The firm's monitoring and remediation process involves activities to (1) evaluate the design, implementation, and operation of the components of the QC system to determine whether the quality objectives have been achieved, and (2) address identified deficiencies in the QC system and engagements. Monitoring and remediation is a crucial part of an effective QC system because it creates a feedback loop to inform the firm's risk assessment process to drive continual improvement.

We are aware that some firms, particularly US global network firms, have made significant efforts to enhance their systems for monitoring and remediation. These efforts include increased attention to ongoing monitoring activities, internal inspections of both in-process and completed engagements, root cause analysis of both positive quality events and deficiencies, and remedial actions to address identified QC deficiencies. Not all firms, however, have made meaningful improvements in these areas.

**Monitoring and remediation is a crucial part of an effective QC system.**

### 1. Requirements of Proposed ISQM 1

Under Proposed ISQM 1, a firm would be required to establish the following quality objectives:

- The firm's monitoring and remediation process provides relevant, reliable and timely information about the design, implementation and operation of the components of the QC system.
- The firm takes appropriate actions to respond to identified deficiencies such that deficiencies are remediated on a timely basis.
- The individual(s) assigned ultimate responsibility and accountability for the QC system evaluates whether the QC system provides reasonable assurance that the objectives of Proposed ISQM 1 have been achieved.

In addition, the proposed standard would require firms to:

- Determine the nature, timing and extent of the monitoring activities, including the appropriate combination of ongoing and periodic monitoring activities. In designing and implementing the monitoring activities, the firm would be required to take into account:
  - o For a response, the related assessed quality risk(s), the reasons for the assessments given to the quality risk(s) and the design of the response;
  - o For monitoring activities over the firm's risk assessment process, the design of that process;
  - o Changes in factors that have affected the firm's QC system or changes in the QC system;
  - o Previous monitoring activities and remedial actions, including whether previous monitoring activities continue to be relevant in evaluating the firm's QC system; and

<sup>100</sup> SECPS member requirements, paragraph 5 of Appendix L, sec.1000.46.

<sup>101</sup> SECPS member requirements Sec. 1000.08(m).

- o Other relevant information, including concerns identified regarding the commitment to quality of the firm or its personnel and information from external inspections.
- Include in its monitoring activities the inspection of engagements to determine whether the responses that are required to be implemented at the engagement level have been implemented. Engagement inspections may include the inspection of in-process or completed engagements. In determining the nature, timing and extent of the inspection of engagements, the firm would be required to:
  - o Take into account the relevant factors from among the factors listed above for designing and implementing monitoring activities; and
  - o Include the inspection of at least one completed engagement for each engagement partner on a cyclical basis determined by the firm.
- Establish policies or procedures that:
  - o Require those performing the monitoring activities to have the competence and capabilities, including sufficient time, to perform the monitoring activities effectively; and
  - o Address the objectivity of the individuals performing the monitoring activities. Such policies or procedures shall prohibit the engagement team members or the engagement quality reviewer of an engagement from performing any inspection of that engagement.
- Establish policies or procedures addressing the evaluation of the findings arising from the monitoring activities, the results of external inspections and other relevant information to determine whether deficiencies exist, including in the monitoring and remediation process.
- Establish policies or procedures addressing:
  - o The investigation of the root cause(s) of the identified deficiencies, including that the nature, timing and extent of the procedures to be performed to investigate the root cause(s) take into account the nature of the identified deficiencies and their possible severity; and
  - o The evaluation of the severity and pervasiveness of the identified deficiencies, including the effect of the identified deficiencies, individually and in aggregate, on the QC system as a whole.
- Design and implement remedial actions to address identified deficiencies that are responsive to the results of the root cause analysis. In doing so, the firm shall determine whether the firm's quality objectives, assessed quality risks and responses remain appropriate and modify them, as appropriate.
- In circumstances when a finding relates to an in-process or completed engagement and there is an indication that procedures required were omitted during the performance of the engagement or the report issued may be inappropriate:
  - o Take appropriate action to comply with relevant professional standards and applicable legal and regulatory requirements; and
  - o When the report is considered to be inappropriate, consider the implications and take appropriate action, including considering whether to obtain legal advice.
- Communicate to personnel information about the monitoring activities performed, the deficiencies identified (including their severity and pervasiveness), and remedial actions to address the deficiencies to the

extent that the information is relevant to their responsibilities to enable the personnel to take prompt and appropriate action in accordance with their responsibilities.

- Communicate information about the results of the firm’s monitoring and remediation process to external parties on a timely basis, in accordance with the requirements for information and communication regarding communication with external parties.

Furthermore, Proposed ISQM 1 would establish the following related requirements for individuals:

- The individual(s) assigned ultimate responsibility and accountability for the QC system would be required to:
  - o Evaluate whether the QC system provides reasonable assurance that the objectives of Proposed ISQM 1 have been achieved, taking into account:
    - The severity and pervasiveness of identified deficiencies; and
    - The evaluation regarding whether the remedial actions are appropriately designed to address the identified deficiencies and their related root cause(s), and have been implemented.

This evaluation is to be undertaken at least annually, or more frequently when the identified deficiencies are of a severity and pervasiveness that indicate that the QC system may not be providing reasonable assurance that the objectives of Proposed ISQM 1 have been achieved.

- o Do the following if the evaluation indicates that the QC system does not provide reasonable assurance that the objectives of Proposed ISQM 1 have been achieved:
  - Take prompt and appropriate action in accordance with their responsibilities; and
  - Communicate to:
    - Personnel to the extent that it is relevant to their responsibilities; and
    - External parties in accordance with the firm’s policies or procedures under the requirements for information and communication regarding communication with external parties.
- The individual assigned operational responsibility for monitoring and remediation to:
  - o Evaluate whether the remedial actions are appropriately designed to address the identified deficiencies and their related root cause(s) and determine whether they have been implemented.
  - o Evaluate whether the remedial actions implemented to address previously identified deficiencies are effective.
  - o Communicate on a timely basis to the individual(s) assigned ultimate responsibility and accountability for the QC system and the individual(s) assigned operational responsibility for the QC system:
    - A description of the monitoring activities performed;
    - The identified deficiencies, including the severity and pervasiveness of such deficiencies; and
    - The remedial actions to address the identified deficiencies.<sup>102</sup>

<sup>102</sup> See paragraphs 42, 44-57 of Proposed ISQM 1.

The IAASB received a number of comments on the proposed requirements regarding the monitoring and remediation process, including requests for additional clarity on identifying deficiencies and performing root cause analysis and concerns about the requirements for the annual evaluation of QC system effectiveness. We will continue to monitor the IAASB's deliberations in this area.<sup>103</sup>

## 2. Potential Incremental or Alternative Requirements for PCAOB Standards

Because of the importance of the monitoring and remediation component, we anticipate that additional direction or alternative requirements would be needed to align with statutory and regulatory requirements and to provide more specific instruction to firms. Specifically, we are considering potential incremental or alternative requirements regarding:

- Monitoring procedures;
- Root cause analysis and remedial actions for QC deficiencies;
- Consideration of engagement deficiencies; and
- Annual evaluation and reporting.

### Monitoring Procedures

We are considering incremental requirements for monitoring procedures to be more proactive, i.e., to prompt firms to perform an appropriate mix of ongoing and periodic procedures.<sup>104</sup> Ongoing monitoring procedures can help firms prevent or timely detect QC problems before they result in deficient engagements.

### Root Cause Analysis and Remedial Actions for QC Deficiencies

While we anticipate a future PCAOB QC standard having analogous requirements to perform root cause analysis and remedial actions, we are assessing whether incremental or alternative requirements will be needed to provide more specific instruction and align with statutory and regulatory requirements in this area.

When a PCAOB report on a firm inspection includes a QC finding, Sarbanes-Oxley provides the firm with an incentive to correct the problem: address the finding to the Board's satisfaction within 12 months, and the finding will remain nonpublic; fail to address it to the Board's satisfaction and the finding will become public.<sup>105</sup> Sarbanes-Oxley does not therefore require a firm to address QC findings to the Board's satisfaction, but it provides a specific incentive for the firm to do so.<sup>106</sup>

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<sup>103</sup> See IAASB September 2019 Board Meeting [Agenda Item 4](#) at 11.

<sup>104</sup> Ongoing monitoring procedures are generally routine operations, built in to firm processes and performed on a real-time basis, reacting to changing conditions. Periodic procedures are generally point-in-time evaluations conducted by objective personnel, internal inspectors, and/or external parties, among others. Periodic procedures can be performed at discrete points during an engagement (e.g., after completion of planning or the performance of interim procedures) or post-engagement.

<sup>105</sup> Sarbanes-Oxley provides that "no portions of the inspection report that deal with criticisms of or potential defects in the quality control systems of the firm under inspection shall be made public if those criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report." See Section 104(g)(2) of Sarbanes-Oxley, 15 U.S.C. § 7214(g)(2).

<sup>106</sup> In the Board's discretion, however, an alleged departure from PCAOB QC standards can become the subject of a Board disciplinary proceeding. See, e.g., *The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports*, PCAOB Release 104-2006-077 (March 21, 2006). That release also provides information about the process for determining whether a firm has addressed QC findings to the satisfaction of the Board for purposes of Section 104(g)(2).

A firm's responsibilities under Proposed ISQM 1, together with potential incremental or alternative requirements, if any, would differ in two respects from the existing process for remediating QC deficiencies identified in PCAOB inspections. First, the potential requirement would apply to identified QC deficiencies from internal and external sources, not just those cited in PCAOB inspection reports. Second, the potential requirement would impose a presumptively mandatory obligation to design and implement remedial actions to address QC deficiencies, whereas the process under the statute provides an incentive without imposing an obligation. Under these two complementary mechanisms, firms would be required to design and implement remedial actions to address QC deficiencies from all sources, and continue to be incented to remediate QC deficiencies cited in inspection reports to the Board's satisfaction within 12 months to avoid public disclosure.

### Consideration of Identified Engagement Deficiencies

Monitoring activities, including internal inspections and evaluating information from regulatory inspections, sometimes identify deficiencies in audits after issuance of the audit report. When this occurs, auditors may have responsibilities under AS 2901, *Consideration of Omitted Procedures After the Report Date*, or AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. AS 2901 describes the considerations and procedures to be applied by an auditor who, subsequent to the date of the report on audited financial statements, concludes that one or more auditing procedures considered necessary at the time of the audit in the circumstances then existing were omitted from the audit of the financial statements, but there is no indication that those financial statements are not fairly presented in conformity with generally accepted accounting principles.<sup>107</sup> AS 2905 addresses situations when, subsequent to the date of the audit report, the auditor becomes aware that facts may have existed at the audit report date that might have affected the report had he or she then been aware of such facts.

We are considering incremental or alternative QC requirements that are aligned more closely with auditors' responsibilities under AS 2901 and AS 2905. (Section V.A. discusses potential changes to AS 2901 that we are considering.) In addition, we are considering an express

## Questions



40. Is the approach to the monitoring and remediation process appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
41. Would the requirements related to monitoring and remediation discussed in this concept release prompt firms to develop an appropriate mix of ongoing and periodic monitoring activities? Would the requirements create an appropriate feedback loop to prevent future engagement deficiencies?
42. Should a future PCAOB QC standard provide additional direction regarding determining appropriate monitoring procedures, appropriate root cause analysis, and remediation of QC and engagement deficiencies? If so, what type of direction is needed?
43. Should all firms, as part of their monitoring procedures, be required to have internal inspections of their completed engagements? If not, which firms should not be required to have inspections of their completed engagements, and what alternative measures should be required for those firms?
44. Should a future PCAOB QC standard establish requirements for internal inspection selection criteria? Should a future PCAOB QC standard specify minimum or cyclical thresholds for inspections of completed engagements by the firm? If so, what should the threshold(s) be (e.g., one engagement for each engagement partner, and/or the audit of each issuer, broker, and dealer on a specified basis)? Should we require selection of engagements for internal inspection to include either random selection or an element of unpredictability?
45. Should firms be required to perform an annual evaluation of their QC system's effectiveness? If so, should the required evaluation be as of a specified date or for a specified period? How should the date or period be determined?

<sup>107</sup> See AS 2901.01.

QC requirement for firm monitoring procedures to include evaluating internal and external inspection findings for the purpose of determining the need for action in accordance with AS 2901 and AS 2905 and for monitoring such remedial actions. These requirements would be intended to prompt firm personnel to give thoughtful consideration to and appropriately respond to identified engagement deficiencies, including implications for other engagements and the QC system.

### Evaluation and Reporting

Proposed ISQM 1 includes a requirement for an assessment, at least annually, of the effectiveness of the QC system. Under a future PCAOB QC standard, we would expect firms to have a reasonable basis for their conclusions regarding QC system effectiveness, and to document the basis for such conclusions, as discussed in Section IV.I.

In addition, we are considering requiring firms to provide annual reports to the PCAOB on their evaluation of the effectiveness of their QC systems. A mandated evaluation and reporting could reinforce the responsibilities of firms and firm leadership—and provide further incentive—to maintain effective QC systems. The concept of reporting on QC effectiveness is analogous to management’s assessment of internal control over financial reporting, which is presented in annual reports of public companies.

Under the requirements we are considering, a firm would be required to annually report its conclusion regarding whether its QC system is effective as of the evaluation date, a brief description of the basis for its conclusion, and if its system is not effective, the reason why, along with any additional measures taken by the firm to make sure that engagements are performed and reports are issued in accordance with PCAOB standards and applicable regulatory requirements. To facilitate the annual reporting on QC system effectiveness, we are considering providing further direction on evaluating the severity of QC deficiencies, including establishing a threshold that would preclude a firm from concluding that its QC system was effective (analogous to a material weakness in internal control over financial reporting).

We are also considering the extent to which the information in the reports should be publicly available. We understand that some firms already publish reports containing statements about the effectiveness of their QC systems, sometimes pursuant to requirements of other jurisdictions.<sup>108</sup> Other firms publish reports making statements about their QC systems without expressing conclusions about effectiveness.

### 3. Information about Current PCAOB Standards

The current PCAOB standards require firms to establish policies and procedures to provide the firm with reasonable assurance that the policies and procedures relating to each of the other elements of quality control are suitably designed and are being effectively applied.<sup>109</sup> As compared with current PCAOB standards, the requirements in Proposed ISQM 1 and potential incremental requirements discussed above would be significant changes. The potential requirements would expand the sources of information to be considered in monitoring and would impose more specific obligations on firms regarding monitoring and remediation, including obligations to undertake root

## Questions



46. Should firms be required to report to the Board on their annual evaluations of QC system effectiveness? If so, what should be included in the report? Should firms be required to disclose any performance measures that were important to their conclusion about their QC system’s effectiveness? Should firm reports be publicly available (see also Question 39)?
47. Should we require the firm’s top leadership to certify as to their QC system’s effectiveness, either as part of or in addition to the firm’s report on their QC system’s effectiveness?

<sup>108</sup> See, e.g., Article 45 (5)(e) of the European Union’s Directive on Statutory Audit 2006/43/EC; and Sections 332 to 332G of the Corporations Act 2001 and Schedule 7A in the Corporations Regulations 2001 (Australia).

<sup>109</sup> See QC 20.20.

cause analysis and remedial actions to address QC deficiencies. Also, they would impose new obligations for an annual evaluation of, and reporting on, QC system effectiveness.

## I. Documentation

Besides the preceding potential requirements for the QC system components, we are considering revising the requirements for documentation related to QC systems.

Documentation supports QC systems in a number of ways. It helps provide clarity around roles and responsibilities, promotes consistency in adhering to firm policies and procedures, enables proper monitoring, and supports evaluation and continual improvement of the QC system.

### 1. Requirements in Proposed ISQM 1

Under Proposed ISQM 1, a firm would be required to:

- Prepare documentation that includes:
  - o QC system documentation sufficient to:
    - Support a consistent understanding of the QC system by personnel, including an understanding of their roles and responsibilities with respect to the firm’s QC system;
    - Support the consistent implementation and operation of the responses; and
    - Provide evidence of the design, implementation and operation of the responses, such that the firm is able to evaluate the QC system.
  - o The firm’s quality objectives and assessed quality risks;
  - o A description of the responses and how the firm’s responses address the assessed quality risks; and
  - o Regarding the monitoring and remediation process:
    - Evidence of the monitoring activities performed;
    - The evaluation of the findings from the monitoring activities, results of external inspections and other relevant information, including the identified deficiencies and their related root cause(s);
    - Remedial actions to address identified deficiencies and the evaluation of the design and implementation of such remedial actions;
    - Communications about monitoring and remediation; and
    - The basis for the evaluation of whether the QC system provides reasonable assurance that the objectives of Proposed ISQM 1 have been achieved.
- Establish a period of time for the retention of documentation for the QC system that is sufficient to permit those performing monitoring procedures to evaluate the firm’s QC system, or for a longer period if required by law or regulation.<sup>110</sup>

<sup>110</sup> See paragraphs 66-67 and 69 of Proposed ISQM 1.

## 2. Potential Incremental or Alternative Requirements for PCAOB Standards

Besides the requirements in Proposed ISQM 1, we are considering incremental provisions for QC documentation that would incorporate concepts from AS 1215 on audit documentation. Specifically, we are considering requiring QC documentation to be:

- Sufficient to enable an experienced auditor that understands QC systems, but has no experience with the design and implementation of the firm's QC system, to understand the basis for the firm's assessment of the effectiveness of the QC system, including evaluation and remediation of QC deficiencies.
- Retained for seven years, unless a longer period is required by law or regulation. This is intended to align the QC document retention requirement with other requirements in PCAOB standards and SEC rules (such as Rule 2-06 of Regulation S-X) because certain QC documentation, such as documentation regarding consultations, may be relevant to audits performed.

We are also considering incremental or additional requirements for firms to document their understanding of network or third party provided methodology and tools, including how such methodology and tools are responsive to the requirements of the professional standards and applicable legal and regulatory requirements.<sup>111</sup>

## 3. Information about Current PCAOB Standards

Current PCAOB standards provide only general direction on the nature and extent of documentation<sup>112</sup> and specific requirements for documentation of certain items.<sup>113</sup> The requirements in Proposed ISQM 1, and potential incremental requirements discussed above, would establish more comprehensive requirements to prompt firms to develop, maintain, and retain appropriate documentation relating to their QC systems.

## Questions



48. Is the approach to documentation appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
49. Are the potential sufficiency and retention period requirements described in this concept release appropriate for a QC system? Why or why not? If not, what alternatives should we consider?
50. Should we require firms to document their understanding of network or third party provided methodology and tools, including how such methodology and tools are responsive to the requirements of the professional standards and applicable legal and regulatory requirements?

<sup>111</sup> See Paragraph 68 of Proposed ISQM 1 for analogous requirements.

<sup>112</sup> QC 20 provides that appropriate consideration should be given to the extent to which QC policies and procedures, and compliance with them, should be documented (QC 20.21); the form, content, and extent of documentation depend on the relevant factors, including the size, structure, and nature of the firm's practice (QC 20.24-.25); a firm should prepare appropriate documentation to demonstrate compliance with its policies and procedures for the QC system (QC 20.25); and documentation should be retained for a period sufficient to enable those performing monitoring procedures and a peer review to evaluate the extent of the firm's compliance with its QC policies and procedures (QC 20.25).

<sup>113</sup> QC 30 and the SECPS member requirements address documentation of certain items, e.g., findings from certain monitoring activities, CPE, notification of cessation of client relationships, filing reviews under Appendix K, and corrective actions to address apparent independence violations. See QC 30.08; SECPS member requirements Sec. 8000; SECPS member requirements Sec. 1000.08(m); SECPS member requirements Appendix K, sec. 1000.45; and SECPS member requirements Appendix L, sec.1000.46.

## J. Roles and Responsibilities of Individuals

We are also considering whether to revise PCAOB QC standards to more expressly address roles and responsibilities for individuals concerning the firm's QC system.

### 1. Requirements in Proposed ISQM 1

Proposed ISQM 1 establishes express requirements for certain roles within the QC system, specifically:

- The individual(s) assigned ultimate responsibility and accountability for the QC system would be required to:
  - Demonstrate a commitment to quality through their actions and behaviors, including recognizing and reinforcing the importance of professional ethics, values and attitudes, and establishing the expected behavior of personnel relating to the performance of engagements and activities within the QC system.
  - Establish structures, reporting lines, and appropriate authorities and responsibilities, including assigning operational responsibility for:
    - The QC system as a whole; and
    - Specific aspects of the QC system, as appropriate to the nature and circumstances of the firm, which shall include operational responsibility for compliance with independence requirements and the monitoring and remediation process.<sup>114</sup>
  - Evaluate whether the QC system provides reasonable assurance that the objectives of Proposed ISQM 1 have been achieved and, if applicable, take certain additional actions as discussed in section IV.H. of this release.<sup>115</sup>
- The individual assigned operational responsibility for monitoring and remediation would be required to evaluate remedial actions for identified QC deficiencies and make certain communications, as discussed in section IV.H. of this release.<sup>116</sup>

Proposed ISQM 1 also mentions certain roles that have operational responsibility.<sup>117</sup>

### 2. Potential Incremental or Alternative Requirements for PCAOB Standards

In addition to the requirements in Proposed ISQM 1 for those with ultimate responsibility and accountability for the QC system and operational responsibility for monitoring and remediation, we are considering incremental requirements that address:

- The individual(s) responsible for independence quality controls; and
- All firm personnel.

We would not prescribe a particular firm structure, nor an exhaustive list of duties for any particular position. Instead, we would address roles that would be expected to exist in any firm, and the general responsibilities associated with those roles.

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<sup>114</sup> See paragraph 24 of Proposed ISQM 1.

<sup>115</sup> See paragraphs 55-57 of Proposed ISQM 1.

<sup>116</sup> See paragraphs 50 and 52 of Proposed ISQM 1.

<sup>117</sup> See, e.g., the reference to operational responsibility for compliance with independence requirements in paragraph 24 of Proposed ISQM 1.

The following are potential incremental requirements that we are considering:

### Responsibility for Independence Quality Controls

- The individual with operational responsibility for independence quality controls would be responsible for:
  - o Overseeing the functioning of the independence policies and procedures, including the firm’s consultation process on independence matters;
  - o Maintaining and disseminating the Restricted Entity List, including:
    - Updating the List on a timely basis;
    - Making the List available to all relevant personnel;
    - Communicating additions to the List on a timely basis to all relevant personnel; and
    - Communicating changes to independence policies and procedures to all relevant personnel.

### All Firm Personnel

- In addition to the specific responsibilities described above, all firm personnel would be responsible for:
  - o Adhering to appropriate standards of conduct, which would include:
    - Fulfilling engagement and QC responsibilities with professional competence, integrity, objectivity, and due professional care, taking into account the public interest.<sup>118</sup>
      - Due professional care includes the exercise of professional skepticism in engagement roles and engagement-related QC roles.<sup>119</sup>
    - Complying with applicable professional standards, regulatory requirements, and the firm’s QC policies and procedures.
  - o Communicating and appropriately responding to information in support of the effective operation of the firm’s QC system or the performance of engagements in accordance with PCAOB standards, including:
    - Reporting complaints and allegations using the channels established by the firm through firm governance and leadership.<sup>120</sup>
  - o Maintaining the competencies needed to fulfill the roles and responsibilities to which they are assigned.
  - o Properly supervising others, in roles that involve supervision.

In addition, we are considering retaining the required responsibilities discussed above for individuals with operational responsibility for independence quality controls (which are currently SECPS member requirements) and extending those requirements to individuals responsible for independence quality controls in all firms.

<sup>118</sup> See, e.g., *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984), in which the U.S. Supreme Court stated, “By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public. This ‘public watchdog’ function demands that the accountant maintain total independence from the client at all times, and requires complete fidelity to the public trust.”

<sup>119</sup> Engagement-related QC roles would include those related to engagement acceptance, consultations, and inspections of in-process or completed engagements.

<sup>120</sup> See the requirements of Proposed ISQM 1 discussed in Section IV.A.1.

The potential requirements for all firm personnel are not expressly set forth in existing QC standards, but they are not entirely new. Rather, they reflect foundational concepts that should be familiar to firms (such as proper supervision), or are aligned with other potential requirements discussed in other portions of this release (such as firm leadership and governance and monitoring and remediation).

In particular, the concept of appropriate standards of conduct reflects a number of concepts in existing PCAOB standards, such as:

- Due professional care (including the exercise of professional skepticism);<sup>121</sup>
- Fulfilling responsibilities with professional competence;<sup>122</sup>
- Integrity and objectivity;<sup>123</sup> and
- Complying with applicable professional standards, regulatory requirements, and the firm's QC policies and procedures.<sup>124</sup>

### 3. Information about Current PCAOB Standards

The combination of Proposed ISQM 1 requirements and potential incremental requirements described above are intended to clarify individuals' responsibilities under PCAOB standards.

Other than independence quality controls,<sup>125</sup> existing QC standards require all firm personnel to comply with firm policies and procedures,<sup>126</sup> but do not specify the individuals' responsibilities. For example, QC 20 requires the assignment of responsibility for the design and maintenance of QC policies and procedures to appropriate individuals, but does not specify the responsibilities of those individuals.<sup>127</sup>

## Questions



51. Should a future PCAOB QC standard specify roles and responsibilities of firm personnel in relation to the firm's QC system?
52. Are the roles and responsibilities described in this concept release appropriate? Are there other roles that should be added (e.g., chief ethics officer, chief technology officer)? Are there further responsibilities that should be added?

<sup>121</sup> See generally AS 1015, *Due Professional Care in the Performance of Work*.

<sup>122</sup> See QC 20.13a, .13b, and .15a.

<sup>123</sup> See, e.g., QC 20.10.

<sup>124</sup> See, e.g., QC 20.03.

<sup>125</sup> See QC 20.09.

<sup>126</sup> See QC 20.03.

<sup>127</sup> See QC 20.22.

## V. RELATED POTENTIAL CHANGES TO OTHER PCAOB STANDARDS

Changes to the QC standards would likely warrant corresponding changes to other PCAOB standards and rules. Most of the changes would be technical in nature, such as conforming terminology and updating references. We anticipate that substantive changes might be needed in the following areas:

- Remediation of engagement deficiencies; and
- Relationship between the auditing standards and the QC standards.

### A. Remediation of Engagement Deficiencies

AS 2901 describes the considerations and procedures to be applied by an auditor who, subsequent to the date of the report on audited financial statements, concludes that one or more auditing procedures considered necessary at the time of the audit in the circumstances then existing were omitted from the audit of the financial statements, but there is no indication that those financial statements are not fairly presented in conformity with generally accepted accounting principles.<sup>128</sup> The standard was originally issued by the AICPA years ago in the era of self-regulation and peer review, and it applied to audits of a variety of entities, not just issuers and SEC-registered brokers and dealers.

Since the standard was originally issued, auditors have become subject to external inspection by regulators, and many firms have enhanced their internal inspection programs. Observations from oversight activities indicate that some firms may not properly fulfill their responsibilities under AS 2901 because they do not fully understand the standard's requirements. We are considering whether updating and clarifying AS 2901 (without changing the auditor's fundamental responsibilities) would prompt better performance of procedures under the standard. For example, we are considering revising AS 2901 to require auditors to:

- Evaluate information coming to their attention indicating that the opinion in a previously issued auditor's report might not have been supported by sufficient appropriate evidence. (Information indicating that a previously expressed opinion might not have been supported by sufficient appropriate evidence could arise from the firm's monitoring activities, an external inspection, or other sources.)
- Apply procedures to obtain sufficient appropriate evidence if persons are relying, or likely to rely, on the auditor's report.

To prompt auditors of brokers and dealers to take appropriate action if they discover that the opinion or conclusion in a previously issued attestation report was not supported, we would also expect to include similar provisions in AT 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, and AT 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*.

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**Since the standard was originally issued, auditors have become subject to external inspection by regulators, and many firms have enhanced their internal inspection programs.**

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<sup>128</sup> See AS 2901.01.

## B. Relationship between the Auditing Standards and the QC Standards

AS 1110, *Relationship of Auditing Standards to Quality Control Standards*, discusses the relationship between the auditing standards and the QC standards. Much of the standard merely repeats requirements of other standards and PCAOB rules, such as obligations to comply with the auditing and QC standards. In addition, AS 1110.03 states:

Auditing standards relate to the conduct of individual audit engagements; quality control standards relate to the conduct of a firm's audit practice as a whole. Thus, auditing standards and quality control standards are related, and the quality control policies and procedures that a firm adopts may affect both the conduct of individual audit engagements and the conduct of a firm's audit practice as a whole.

However, deficiencies in or instances of noncompliance with a firm's quality control policies and procedures do not, in and of themselves, indicate that a particular audit engagement was not performed in accordance with the auditing standards.

Although these statements are rather obvious, the last sentence could be misunderstood. Auditors could misread that sentence as suggesting that noncompliance with firm quality controls does not affect the quality of audits, when in fact, observations from oversight activities indicate that many audit deficiencies occur when engagement teams do not follow quality control standards or firm policies and procedures, including methodologies or guidance.

We seek comment on whether AS 1110 provides helpful direction to auditors or whether it should be rescinded. If we retain AS 1110, we are considering removing or revising the last paragraph for the reasons described above.

### Questions



53. Are the potential amendments to AS 2901 appropriate? Are there other approaches we should consider to prompt firms to appropriately respond when there are indications calling into question the sufficiency of audit procedures performed and/or audit evidence obtained?
54. Does AS 1110 provide helpful direction to auditors, or should it be rescinded? Please provide explanation for your answer.
55. Are there other PCAOB standards for which substantive changes might be needed to align with a future PCAOB QC standard?

## VI. SCALABILITY

A wide variety of firms are subject to the PCAOB's quality control standards, ranging from large firms with thousands of partners that are members of global networks, to small firms of just one or two partners with a local practice. While the basic objectives of the quality control system are the same across all firms, the processes and controls necessary to achieve those objectives could vary significantly. Any future PCAOB QC standard would have to be scalable, so that firms could appropriately design their quality control systems to address the risks associated with their own practice. In considering the need for scalability and consistent with the IAASB's deliberations, the Board anticipates that relevant factors would include:

- the size of the firm;
- the complexity of the firm; and
- the nature of the firm's engagements.<sup>129</sup>

For example, a future PCAOB QC standard could, depending on the associated quality risks, contemplate less formal processes and controls by smaller, less complex firms and more robust, formal processes and controls for larger, more complex firms.

We seek comment on how to make a future PCAOB QC standard appropriately scalable, including whether there are other factors we should consider.

### Questions



56. We intend that a future PCAOB QC standard developed using this approach would be applicable to all firms and scalable based on their size and complexity and the nature of their engagements. What factors should we consider when developing a future PCAOB QC standard to ensure that its requirements are appropriately scalable?
57. Are there aspects of the approach described in this concept release that would disproportionately affect smaller firms? If so, which areas, and what steps could the PCAOB consider to mitigate those effects?
58. Should we have additional, more specific requirements regarding certain components or areas (e.g., governance and leadership) for larger, more complex firms or based on the nature of engagements performed by the firm (e.g., broker and dealer engagements or engagements for issuers in specialized industries)? If so, what should those be?

<sup>129</sup> The IAASB is also considering scalability. See paragraphs 85-89 of the IAASB Explanatory Memorandum accompanying Proposed ISQM 1 at p. 28-29 for discussion regarding scalability.

## VII. QUESTIONS

You are encouraged to comment on any or all topics and respond to any or all questions and to provide any evidence (e.g., data or practical experiences) that informs your views.

### Introduction

1. Should PCAOB QC standards be revised to address developments in audit practices and provide more definitive direction regarding firm QC systems? Are there other reasons for changes to the QC standards that we should take into account?
2. Is it appropriate to use ISQM 1 as the basis for a future PCAOB QC standard? Are there alternative approaches we should consider?
3. Are the reasons provided for differences between ISQM 1 and a future PCAOB QC standard appropriate? Are there other potential reasons for differences that we should consider?

### Background and Considerations for Potential Revisions to QC Standards

4. Are there other developments affecting audit practices we should consider addressing in a future PCAOB QC standard?
5. To the extent that audit firms are already updating or making enhancements to their QC systems to align with international developments, can you characterize the nature and extent of those changes and related efforts? What benefits do you anticipate from updates to QC systems?
6. Please provide references to any academic studies or data we should consider, including academic studies or data that might address costs and benefits relevant to an economic analysis of potential revisions to PCAOB QC standards.

### Potential Standard-Setting Approach Based on Proposed ISQM 1

7. Would the approach to quality control standards described in this concept release be preferable to the current PCAOB quality control standards?
8. Would the objective of a quality management system provided in Proposed ISQM 1 be an appropriate objective for a QC system under PCAOB standards? Are there additional objectives that a quality control system should achieve?
9. Would the potential revisions to PCAOB QC standards described in this concept release improve QC systems and audit quality?
10. Would the potential revisions to PCAOB QC standards described in this concept release enhance firms' ability to prevent audit deficiencies? Are there additional revisions to PCAOB QC standards that we should consider to support a preventive approach to managing quality?
11. Should a future PCAOB QC standard have additional or alternative requirements for firms that audit brokers and dealers? If so, what?

## Specific Aspects of a QC System and Potential Changes to PCAOB Standards

12. What would be the costs and benefits of implementing and maintaining an integrated QC system as described in this concept release? Are there particular costs and benefits associated with specific components that we should consider? What, if any, unintended consequences would there be?

## Firm Governance and Leadership

13. Is the approach to firm governance and leadership appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
14. Would more clarity in the assignment of firm supervisory responsibilities enhance supervision and positively affect QC systems and audit quality?
15. Should a future PCAOB QC standard address quality considerations in the appointment of a firm's senior leadership? If so, how?
16. Allocation of financial resources is one aspect of firm governance and leadership under Proposed ISQM 1. Should this be given greater emphasis in a future PCAOB QC standard than it is given in Proposed ISQM 1? For example, should a future PCAOB QC standard emphasize the importance of counterbalancing commercial interests that may lead to underinvestment in the audit and assurance practice, particularly in firms that also provide non-audit services?
17. Should a future PCAOB QC standard incorporate mechanisms for independent oversight over firms' QC systems (e.g., boards with independent directors or equivalent)? If so, what criteria should be used to determine whether and which firms should have such independent oversight (e.g., firm size or structure)? What requirements should we consider regarding the qualifications and duties of those providing independent oversight?

## The Firm's Risk Assessment Process

18. Is the approach to the firm's risk assessment process appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
19. Are principles-based requirements sufficient to prompt firms to appropriately identify, assess, and respond to risks, or is supplemental direction needed? If supplemental direction is needed, what requirements would assist firms in identifying, assessing, and responding to risks?
20. Should a future PCAOB QC standard specify certain quality risks that must be assessed and responded to by all firms? If so, what should those risks be?
21. Should firms be required to establish quantifiable performance measures for the achievement of quality objectives? If so, how should such measures be determined and quantified (see also Question 46)?

## Relevant Ethical Requirements

22. Is the approach to relevant ethical requirements appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
23. Should a future PCAOB QC standard extend detailed requirements for independence quality controls (formerly SECPS member requirements) to all firms? How would this affect the costs and benefits of a QC system?

## Acceptance and Continuance of Clients and Engagements

24. Is the approach to acceptance and continuance of clients and engagements appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?

## Engagement Performance

25. Is the approach to engagement performance appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
26. Should a future PCAOB QC standard expressly address firm responsibilities and actions to support and monitor the appropriate application of professional skepticism and significant judgments made by engagement teams? If so, how?
27. Should a future PCAOB QC standard expressly address the use of other audit participants? If so, should the scope of the requirements include affiliated and non-affiliated entities and individuals, including specialists and service delivery centers? Should we consider any changes to the scope of the potential requirements described? If so, what changes would be necessary?
28. Should the Appendix K requirements be retained? Should the scope or application of the Appendix K requirements be changed, for example to extend the requirements to all audits in which a non-U.S. firm issues an audit report on the financial statements of an issuer, or to exempt certain audits from one or more requirements? Should the individual requirements in Appendix K for filing reviews, inspection procedures, or disagreements be revised or updated? If so, how? Is it clear how the responsibilities of an Appendix K reviewer differ from the role of the engagement quality reviewer?
29. Should a future PCAOB QC standard require firms to adopt engagement monitoring activities (e.g., performance measures, engagement tracking tools, or reviews of in-process engagements) that would prompt them to proactively prevent or detect engagement deficiencies? What are examples of less formal, but effective, engagement monitoring activities that could be adopted by smaller firms?
30. How should a future PCAOB QC standard expressly address firms' actions to support the fulfillment of the auditor's responsibilities under Section 10A of the Exchange Act, including:
  - a. With respect to fraud?
  - b. With respect to other illegal acts?
  - c. With respect to going concern consideration?

## Resources

31. Is the approach to resources appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
32. Should a future PCAOB QC standard continue to expressly address technical training on professional standards and SEC requirements? Are there other subjects for which training should be expressly required? Which firm personnel should be covered by the training requirements? Should the standards set minimum requirements for the extent of training? If so, what should those requirements be based on?
33. Should a future PCAOB QC standard continue to expressly address required competencies of engagement partners? Are the competencies discussed in this concept release appropriate? Are there other competencies that should be added?

34. Should the competencies of individuals in engagement or QC roles, in addition to the engagement partner and engagement quality reviewer, be addressed in a future PCAOB QC standard?
35. Should a future PCAOB QC standard expressly address the use of emerging technology in QC systems or engagements? Should a future PCAOB QC standard expressly require firms to design and implement controls to prevent unauthorized access to technology and data? Are there any other requirements we should consider related to the use of technology on engagements?
36. Ensuring that firm personnel in QC and engagement roles have sufficient time to properly carry out their responsibilities is one aspect of firm resources under Proposed ISQM 1. Should a future PCAOB QC standard place greater emphasis on this requirement than Proposed ISQM 1 does? If so, how?
37. Should a future PCAOB QC standard expressly address how the firm's incentive system, including compensation, incorporates quality considerations? If so, how?

## Information and Communication

38. Is the approach to information and communication appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
39. Should a future PCAOB QC standard require public disclosure by firms about their QC systems? If so, what should be the nature and timing of such disclosures (e.g., information about the firm's governance structure)? (see also Question 46)

## The Monitoring and Remediation Process

40. Is the approach to the monitoring and remediation process appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
41. Would the requirements related to monitoring and remediation discussed in this concept release prompt firms to develop an appropriate mix of ongoing and periodic monitoring activities? Would the requirements create an appropriate feedback loop to prevent future engagement deficiencies?
42. Should a future PCAOB QC standard provide additional direction regarding determining appropriate monitoring procedures, appropriate root cause analysis, and remediation of QC and engagement deficiencies? If so, what type of direction is needed?
43. Should all firms, as part of their monitoring procedures, be required to have internal inspections of their completed engagements? If not, which firms should not be required to have inspections of their completed engagements, and what alternative measures should be required for those firms?
44. Should a future PCAOB QC standard establish requirements for internal inspection selection criteria? Should a future PCAOB QC standard specify minimum or cyclical thresholds for inspections of completed engagements by the firm? If so, what should the threshold(s) be (e.g., one engagement for each engagement partner, and/or the audit of each issuer, broker, and dealer on a specified basis)? Should we require selection of engagements for internal inspection to include either random selection or an element of unpredictability?
45. Should firms be required to perform an annual evaluation of their QC system's effectiveness? If so, should the required evaluation be as of a specified date or for a specified period? How should the date or period be determined?

46. Should firms be required to report to the Board on their annual evaluations of QC system effectiveness? If so, what should be included in the report? Should firms be required to disclose any performance measures that were important to their conclusion about their QC system's effectiveness? Should firm reports be publicly available (see also Question 39)?
47. Should we require the firm's top leadership to certify as to their QC system's effectiveness, either as part of or in addition to the firm's report on their QC system's effectiveness?

## Documentation

48. Is the approach to documentation appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?
49. Are the potential sufficiency and retention period requirements described in this concept release appropriate for a QC system? Why or why not? If not, what alternatives should we consider?
50. Should we require firms to document their understanding of network or third party provided methodology and tools, including how such methodology and tools are responsive to the requirements of the professional standards and applicable legal and regulatory requirements?

## Roles and Responsibilities of Individuals

51. Should a future PCAOB QC standard specify roles and responsibilities of firm personnel in relation to the firm's QC system?
52. Are the roles and responsibilities described in this concept release appropriate? Are there other roles that should be added (e.g., chief ethics officer, chief technology officer)? Are there further responsibilities that should be added?

## Related Potential Changes to Other PCAOB Standards

53. Are the potential amendments to AS 2901 appropriate? Are there other approaches we should consider to prompt firms to appropriately respond when there are indications calling into question the sufficiency of audit procedures performed and/or audit evidence obtained?
54. Does AS 1110 provide helpful direction to auditors, or should it be rescinded? Please provide explanation for your answer.
55. Are there other PCAOB standards for which substantive changes might be needed to align with a future PCAOB QC standard?

## Scalability

56. We intend that a future PCAOB QC standard developed using this approach would be applicable to all firms and scalable based on their size and complexity and the nature of their engagements. What factors should we consider when developing a future PCAOB QC standard to ensure that its requirements are appropriately scalable?
57. Are there aspects of the approach described in this concept release that would disproportionately affect smaller firms? If so, which areas, and what steps could the PCAOB consider to mitigate those effects?
58. Should we have additional, more specific requirements regarding certain components or areas (e.g., governance and leadership) for larger, more complex firms or based on the nature of engagements performed by the firm (e.g., broker and dealer engagements or engagements for issuers in specialized industries)? If so, what should those be?

## VIII. OPPORTUNITY FOR PUBLIC COMMENT

The Board will seek comment for a 90-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to the Office of the Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted by email to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's website at [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to PCAOB Rulemaking Docket Matter No. 046 in the subject or reference line. Comments should be received no later than March 16, 2020. The Board will consider all comments received.

On the 17th day of December, in the year 2019, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD

/s/ Phoebe W. Brown

Phoebe W. Brown  
Secretary

December 17, 2019

# Appendix 1

## List of PCAOB QC Standards

Standard	Title	Description
<b>General Standards</b>		
QC 20	<i>System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>	Requires a firm to have a QC system for its accounting and auditing practice and describes elements of QC and other matters essential to the effective design, implementation, and maintenance of the system.
QC 30	<i>Monitoring a CPA Firm's Accounting and Auditing Practice</i>	Supplements QC 20 by providing further direction on implementing the monitoring element of a QC system.
QC 40	<i>The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement</i>	Supplements QC 20 by clarifying the requirements regarding the competencies of the engagement partner, who is the individual responsible for the engagement.
<b>SECPS Member Requirements</b>		
SECPS §1000.08(d)	<i>Continuing Professional Education of Audit Firm Personnel</i>	Establishes minimum continuing professional education requirements for personnel of member firms.
SECPS §1000.08(l)	<i>Communication by Written Statement to all Professional Personnel of Firm Policies and Procedures on the Recommendation and Approval of Accounting Principles, Present and Potential Client Relationships, and the Types of Services Provided</i>	Requires communication to professional personnel regarding (1) the broad principles that influence the member firm's policies and procedures on specified matters and (2) compliance with those principles.
SECPS §1000.08(m)	<i>Notification of the Commission of Resignations and Dismissals from Audit Engagements for Commission Registrants</i>	Requires member firms to report the cessation of a client-auditor relationship to the client and SEC staff.
SECPS §1000.08(n)	<i>Audit Firm Obligations with Respect to the Policies and Procedures of Correspondent Firms and of Other Members of International Firms or International Associations of Firms</i>	Requires member firms associated with international firms or networks to seek adoption (by the international firms or network) of policies and procedures regarding filing reviews, inspection procedures, and disagreements.
SECPS §1000.08(o)	<i>Policies and Procedures to Comply with Independence Requirements</i>	Requires member firms to have certain policies and procedures related to independence.

## Appendix 2

### APPENDIX L—Independence Quality Controls

#### Introduction

Member firms<sup>1</sup> must comply with the applicable independence standards promulgated by the American Institute of Certified Public Accountants (AICPA), Independence Standards Board (ISB), and the Securities and Exchange Commission (SEC). The importance of compliance with such independence standards, and the quality control standards promulgated by the AICPA, should be reinforced by the management of the member firm, thereby setting the appropriate “tone at the top” and instilling its importance into the professional values and culture of the member firm. Member firm management should also foster an environment where the seriousness and importance of compliance can be evidenced in many forms, such as the member firm’s commitment to the training of professionals on independence policies and the action taken in the case of non-compliance with such policies.

#### Requirements

1. Each member firm shall establish written independence policies covering relationships with “restricted entities,” for example, relationships between the restricted entity and the member firm (including, where applicable, its foreign-associated firms<sup>2</sup>), its benefit plans, and its professionals. These policies shall be written in language, to the extent possible, that is clear, concise, and tailored to each member firm’s independence policies and procedures, given the complexity of the member firm’s practice. These relationships would include investments, loans, brokerage accounts, business relationships, employment relationships, proscribed services, and fee arrangements. For purpose of this membership requirement, “restricted entities” shall include all audit clients of the member firm, and to the extent applicable its foreign-associated firms, that are SEC registrants and other entities<sup>3</sup> that the member firm is required to be independent of under the applicable SEC requirements.
  - a. Persons classified as “professional staff” (including partners) in a member firm’s annual report to the SEC Practice Section (SECPS) shall be considered “professionals” for this purpose.
  - b. For purposes of implementing these requirements, the term “SEC registrant” is defined as (1) an issuer making an initial filing, including amendments, under the Securities Act of 1933 or the Securities Exchange Act of 1934 (“Exchange Act”); (2) a registrant that files periodic reports under the Investment Company Act of 1940 or the Exchange Act; (3) a bank or other lending institution that files periodic reports under the Exchange Act with the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, or the Office of Thrift Supervision; (4) a company whose financial statements appear in the annual report or proxy statement of an investment fund because it is a sponsor or manager of such a fund, but which is not itself a registrant required to file periodic reports under the Investment Company Act of 1940 or section 13 or 15(d) of the Exchange Act; and (5) a foreign private issuer defined by Rule 405 of Regulation C under the Securities Act of 1933 and Rule 3b-4(c) under the Exchange Act that has securities registered or has filed a registration statement with the SEC.

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#### Footnotes (.46 APPENDIX L—Independence Quality Controls):

- <sup>1</sup> For purposes of this requirement, *member firm*, unless otherwise noted, means the U.S. firm that is the member of the SEC Practice Section.
- <sup>2</sup> For purposes of this requirement, a *foreign-associated firm* is an organization outside of the United States and its territories that would normally include only those organizations that are reported on the member firm’s annual report to the SECPS in accordance with §1000.08(n) and Appendix K of the SECPS Reference Manual, but could include other organizations based on facts and circumstances.
- <sup>3</sup> For practical purposes, member firms may exclude entities whose securities are not available for public sale.

2. The member firm's independence policies shall be provided or otherwise made available to all professionals, as defined in paragraph 1(a). Substantive changes to the member firm's policies shall be provided or otherwise made available on a timely basis.
3. The member firm shall establish a training program to provide reasonable assurance that professionals understand the member firm's independence policies. Each professional performing professional services for clients shall complete near the time of initial employment and periodically thereafter, independence training as required by the member firm's policies. The specific content and extent and timing of the independence training requirements shall be determined by the member firm's policies, but shall include the relevant rules regarding investments, loans, brokerage accounts, business relationships, employment relationships, proscribed services and fee arrangements.
4. Each member firm shall maintain a database ("Restricted Entity List") that includes all restricted entities, as described in paragraph 1. The member firm's policies should explain why, when and how SEC registrant audit clients (and other related entities as discussed above) are to be placed on the Restricted Entity List. For member firms that provide an annual audit to more than 500 SEC registrants, an automated system to identify investment holdings of partners and managers that might impair independence is required. Member firms that provide an annual audit to more than 500 SEC registrants are required to have the automated system in place by December 31, 2000 or within a reasonable transition period upon achieving that number, not to exceed one year.
5. Each member firm shall designate a senior-level partner responsible for: (1) overseeing the adequate functioning of the independence policies of and the consultation process within the member firm; (2) providing or otherwise making the Restricted Entity List readily available to all professionals; (3) keeping the Restricted Entity List updated on at least a monthly basis; and (4) communicating additions to the Restricted Entity List on a timely basis (generally monthly).
6. Member firms that have foreign-associated firms shall provide or otherwise make available the member firm's independence policies, required in paragraph 1, and its Restricted Entity List, required in paragraph 4, to its foreign-associated firms, including the partners and managers therein. This may be accomplished directly by the member firm, by an international organization of which the member firm is a participating firm, or by a foreign-associated firm.
7. Each member firm's independence policies and procedures should specifically require the following:
  - a. Prior to obtaining any security or other financial interest in an entity, professionals should review the Restricted Entity List to determine whether the entity is included thereon. This review would also be required by the professional's spouse and dependents.
  - b. Each professional shall certify near the time of initial employment and at least annually thereafter that he or she (1) has read the member firm's independence policies, (2) understands their applicability to his or her activities and those of his or her spouse and dependents, and (3) has complied with the requirements of the member firm's independence policies since the prior certification.<sup>4</sup>
  - c. Each professional shall report apparent violations of policies involving himself or herself and his or her spouse and dependents and the corrective action taken or proposed to be taken on a timely basis when identified. Reporting apparent violations under this requirement would not include, for example, timely disposition of client securities resulting from additions to the Restricted Entity List or upon becoming subject to the independence rules of the ISB, SEC or AICPA.

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#### Footnotes (.46 APPENDIX L—Independence Quality Controls):

<sup>4</sup> The provisions of paragraph 7(b) are effective April 1, 2000 and shall be applied prospectively.

- d. Each member firm shall have a monitoring system under the supervision of the senior-level partner designated in 5 above to determine that adequate corrective steps are taken and documented on all apparent violations reported by professionals within the member firm. The monitoring system should include procedures to provide reasonable assurance that (i) investments of the member firm and its benefit plans are in compliance with the member firm's policies and (ii) information received from its partners and managers is complete and accurate. The monitoring system will generally include auditing, on a sample basis, selected information such as brokerage statements, or alternative procedures that accomplish the same objective.
- e. Each member firm shall develop as part of its policies, guidelines for actions to be taken against professionals for violations of independence. These policies will describe the potential sanctions to levy against those professionals for violating member firm policies and procedures or professional independence requirements.

## Appendix 3

### Appendix K—SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants

**.01** The Section acknowledges that SECPS member firms that are members of, correspondents with, or similarly associated with international firms or international associations usually do not control their international organization or individual foreign associated firms.<sup>1</sup> However, the Section adopted the membership requirement set forth in SECPS §1000.08(n) to obtain the assistance of SECPS member firms in their seeking to enhance the quality of SEC filings by SEC registrants<sup>2</sup> whose financial statements are audited by foreign associated firms. This assistance consists of SECPS member firms seeking adoption of policies and procedures by their international organizations or individual foreign associated firms that are consistent with the following objectives:

- a. *Procedures for Certain Filings by SEC Registrants*—The policies and procedures should address the performance of procedures with respect to certain SEC filings by SEC registrants that are clients of foreign associated firms by a person or persons knowledgeable in accounting, auditing, and independence standards generally accepted in the U.S., independence requirements of the SEC and ISB, and SEC rules and regulations in areas where such rules and regulations are pertinent (the “filing reviewer”). The procedures are performed to provide assistance to the partner of the foreign associated firm responsible for the audit (the “audit partner-in-charge of the engagement”) and the foreign associated firm. Such filings are limited to registration statements, annual reports on Form 20-F and 10-K, and other SEC filings that include or incorporate the foreign associated firm’s audit report on the financial statements of an SEC registrant.

The procedures performed by the filing reviewer should generally include the following:

- (1) Reading the document to be filed with the SEC with particular attention given to compliance as to form of the financial statements (and related schedules) and auditors’ report with the applicable accounting and financial reporting requirements for such filings by the SEC registrant.
- (2) Discussing with the audit partner-in-charge of the engagement:
  - (i) the engagement team’s familiarity with and understanding of the applicable U.S. auditing, accounting, financial reporting, and independence standards, including independence requirements of the SEC and the ISB;
  - (ii) the significant differences between: (a) the accounting and financial reporting standards used in the presentation of the financial statements included or incorporated in the document to be filed with the SEC and those applicable in the U.S., and (b) the auditing and independence standards of the foreign associated firm’s domicile country and those applicable in the U.S.; and
  - (iii) any significant auditing, accounting, financial reporting, and independence matters that come to the attention of the filing reviewer when performing the procedures described above, including how any such matters were addressed and resolved by the audit partner-in-charge of the engagement.

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#### Footnotes (.45 Appendix K—SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants):

<sup>1</sup> For this purpose, a foreign associated firm is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international firm or international association of firms with which the SECPS member is associated.

<sup>2</sup> See Appendix D, SECPS §1000.38, “Definition of an SEC Engagement” for purposes of determining compliance with the membership requirements of SECPS §1000.08e, f, g, h, i, k, m, n, o and p.

(3) Documenting the results of the procedures performed.

The procedures performed by the filing reviewer described above do not relieve the audit partner-in-charge of the engagement of any of the responsibilities for the performance of the audit of, and the report rendered by the foreign associated firm on, the financial statements included in the document to be filed with the SEC. Also, the filing reviewer does not assume any of the responsibilities of the audit partner-in-charge of the engagement or of any concurring reviewer.

Because of the limited nature of the procedures described above, it is recognized that the filing reviewer can not and does not assume any responsibility for detecting a departure from, or noncompliance with, accounting, auditing, and independence standards generally accepted in the U.S., independence requirements of the SEC and ISB, or SEC rules and regulations.

- b. Inspection Procedures*—The policies and procedures should address the review of a sample of audit engagements performed by foreign associated firms for clients that are SEC registrants. Such reviews may be performed as part of an annual inspection program of the international organization or the individual foreign associated firms. The reviews of engagements should be performed by a person or persons knowledgeable in accounting, auditing, and independence standards generally accepted in the U.S., independence requirements of the SEC and ISB, and SEC rules and regulations in areas where such rules and regulations are pertinent (the “inspection reviewer”). The need for knowledge of relevant specialized industry practices should be considered.

Based on the procedures performed, the inspection reviewers should determine whether anything came to their attention to cause them to believe that:

- (1) the financial statements were not presented in all material respects in conformity with accounting principles generally accepted in the U.S. or, if applicable, the footnote reconciliation of the financial statements to U.S. GAAP did not include appropriate treatment of the material reconciling items,
  - (2) the audit engagement was not performed in accordance with auditing standards generally accepted in the U.S.,
  - (3) the document(s) filed with the SEC did not comply as to form of the financial statements (and related schedules) with pertinent SEC rules and regulations for such filings,
  - (4) the foreign associated firm did not comply with the applicable U.S. independence standards, including independence requirements of the SEC and ISB with respect to the SEC registrant, or
  - (5) the foreign associated firm did not comply with procedures consistent with those described in .01a. above.
- c. Disagreements*—The policies and procedures should provide that if the filing or inspection reviewer and the audit partner-in-charge of the engagement have conflicting views as to the resolution of matters that came to the attention of the filing or inspection reviewer when performing the procedures for certain filings or inspection described above, that disagreement should be resolved in accordance with the applicable policy of the international organization or of the filing or inspection reviewer’s firm.

