ICAEW REPRESENTATION 129/17

Supplemental Request for Comment: Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard — *Dividing Responsibility for the Audit with Another Accounting Firm*

ICAEW welcomes the opportunity to comment on the Supplemental Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard — *Dividing Responsibility for the Audit with Another Accounting Firm* published by PCAOB on 26 September 2017, a copy of which is available from this link.

This response of 15 November 2017 has been prepared on behalf of ICAEW by the Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

The Institute of Chartered Accountants in England and Wales
Chartered Accountants' Hall
Moorgate Place
London
EC2R 6EA
UK

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
icaew.com

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 147,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

For more information, please contact: representations@icaew.com

icaew.com

MAJOR POINTS

1. We welcome these supplemental proposals relating to the supervision of audits involving other auditors and the proposed auditing standard on dividing responsibility for audits with other accounting firms. The audit of group financial statements is, increasingly, a technically and logistically complex exercise.

2. We welcome the fact that the PCAOB has taken account of comments received on its 2016 consultation and is considering revising its proposals as a result of those comments. In particular, we welcome:

   - the removal of the proposed requirement for lead auditors to record a description of other auditor documentation reviewed but not retained;

   - the removal of the proposed requirement for certain communications to be made directly between lead auditors and second other auditors, bypassing first other auditors;

   - the acknowledgement that summary memoranda are widely used in practice and that a good audit trail is important in any audit involving more than one auditor, but that the content of summary memoranda vary extensively depending on individual circumstances.

More use of first other auditors will result in greater efficiency and, potentially, effectiveness

3. The revised proposed requirements are an improvement but there is still scope for better use of first other auditors in multi-tiered audits without compromising audit quality. For example, the revised proposed requirement for lead auditors to obtain, review and retain a summary memorandum from second other auditors through the first other auditor, rather than directly from the second other auditor is a step forward but it is still far from reflective of the manner in which companies and their auditors actually operate.

4. We fully acknowledge the need for lead auditors to engage with second other auditors directly without reference to first other auditors. Simply relying on controls without testing them or performing substantive checks around them is not enough. In any business, those with high level responsibilities must attend to the reports of those they appoint to manage business activities but from time to time they must also 'walk the floor', to understand what is actually happening and to encourage diligence in reporting. But if the need to check is paramount and the controls designed to form a basis for trust are never tested, such controls become redundant, or duplicative at best. There is little point in appointing a layer of middle management if senior management ignores it and continues to manage the business as if it was not there.

5. Control systems necessarily cascade responsibilities through a hierarchical reporting structure to be efficient and effective. If the attempted span of control at a high level is too wide, it fails and it is impossible to control everything from the top. The revised requirements would be therefore be further improved if they acknowledged more clearly the critical role of the risk assessment that is, in practice, carried out at all levels. The PCAOB should acknowledge properly the ability of first other auditors to effectively supervise and monitor second (and more) other auditors.

6. Lead auditors will in practice make use of the lines of responsibility and reporting in multi-tiered audits in performing their risk assessments and determining their responses. They will focus on the summary memoranda obtained from first other auditors, which in turn will cover the work of

second other auditors. Summary memoranda are in practice 'cascaded up' through reporting hierarchies. If the PCAOB also requires lead auditors to obtain, review and retain summary memoranda from second other auditors, they will of course do so, but as a compliance exercise and in a perfunctory manner, because that is what the PCAOB expects, and what PCAOB inspectors will seek to inspect. The matters covered in those memoranda will already have been covered off. Similar considerations apply in respect of compliance with independence and other ethical requirements.

The rebuttable presumption

7. Situations in which audit firms find that they have responsibilities as lead auditors but very little involvement in the audit of the group as a whole are not uncommon, as a result of mergers, acquisitions, changes in auditors and independence requirements. Support within auditing standards to help auditors obtain appropriate audit evidence in such situations is necessary. Within International Standards on Auditing (ISAs), the principal mechanism by which this is achieved is by requiring the same level of work effort and quality of audit evidence by lead auditors, regardless of their level of involvement.

8. The immediate consequences of the proposed rebuttable presumption that lead auditors should audit 50% of assets and revenues in divided responsibility situations are likely to be insignificant. As the PCAOB notes, divided responsibility remains relatively rare (at least for the time being), the area is already covered by an SEC rule and the 50% threshold represents common industry practice. It is clearly in the public interest that lead auditor involvement is adequate, and at first glance, the 50% rebuttable presumption makes sense. Nevertheless, we have to date opposed any such suggestions because they rarely, if ever, operate as intended. The proposal focuses disproportionate attention on a very narrowly scoped area and despite the Board's best intentions it is likely to be misinterpreted as a bright-line rule.

9. It would therefore be helpful for the PCAOB to make it clear that it does not intend to effectively prohibit situations in which lead auditors audit less than 50% of the group as a whole, and that its intention is to require auditors to make a good case in such situations. A note within the standard and/or a staff publication discussing cases already identified by the PCAOB of situations in which it may be appropriate to rebut the presumption would be helpful. Those identified by the PCAOB include late stage mergers and acquisitions but there are more. The discussion should cover other factors affecting the decision such as the use of shared service centres, equity method investments and joint ventures, and auditor rotation requirements.

10. A further unintended consequence is likely to be further negative pressure on competition in the audit market. This is less of an issue in the USA than elsewhere but a limited choice of auditors for US businesses located outside the USA affects US investors.

Divided responsibility

11. The Board at one and the same time appears to acknowledge that divided responsibility causes little mischief - it states that there are relatively few such audits - but then goes on to deal with the issue as if it believes it is a problem, or is likely to become one. It notes a belief among some commenters that the number of such engagements is likely to increase.

12. We respectfully suggest that while it may sometimes be difficult for lead auditors to supervise the work of other firms, and a specific audit approach may be impracticable in a specific area for a specific entity, it is rarely if ever wholly 'impracticable' for lead auditors to supervise other auditors. We do not believe that divided responsibility serves US investors well and we do not believe that the PCAOB should continue to support a differential approach to divided responsibility, still less extend it to situations in which different financial reporting frameworks are in use.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Is the revised requirement for determining the sufficiency of participation to serve as lead auditor, based on risk and importance of the locations, appropriate and clear?

13. The proposed revised requirement for lead auditors to consider the importance (quantitatively and qualitatively) of the locations or business units on which they perform procedures, in relation to the financial statements as a whole, seems reasonable. We believe that auditors generally do this already but it is helpful to have it set out in auditing standards for auditors negotiating with clients in situations in which lead auditors have relatively little participation in the wider group audit.

Q2: Is the additional sufficiency threshold for divided responsibility engagements clear? Should this be a bright-line requirement, or does this threshold need to allow for exceptional situations? Are there any other implications of this threshold that the Board should consider, such as investor protection implications or auditing challenges related to the revised requirement?

14. We note in our main points above our belief that the immediate consequences of the proposed rebuttable presumption that lead auditors audit 50% of assets and revenues are likely to be insignificant but that despite the PCAOB's best intentions, the proposal:

    - focuses disproportionate attention on a very narrowly scoped area and is open to misinterpretation as a bright-line rule;

    - is likely to result in additional pressure on competition in the audit market which affects many US investors who have interests in US businesses with operations outside the USA.

15. ICAEW has to date opposed such proposals because they rarely, if ever, operate as intended. It would therefore be helpful for the PCAOB to make it clear that it does not intend to effectively prohibit situations in which lead auditors audit less than 50% of the group as a whole and that its intention is to require auditors to make a good case in such situations. A note within the standard and/or a staff publication discussing cases already identified by the PCAOB of situations in which it may be appropriate to rebut the presumption would be helpful. Those identified by the PCAOB include late stage mergers and acquisitions but there are more. The discussion should cover other factors affecting the decision such as the use of shared service centres, equity method investments and joint ventures, and auditor rotation requirements.

16. More generally, we do not believe that divided responsibility serves US investors well and we do not believe that the PCAOB should continue to support a differential approach to divided responsibility, still less extend it to situations in which different financial reporting frameworks are in use. It may be difficult for lead auditors to supervise the work of other firms in some cases, and a specific audit approach may be impracticable in a specific area for a specific entity, but it is rarely if ever wholly 'impracticable' for lead auditors to supervise other auditors.

Q3: Are the revised requirements relating to the other auditors' compliance with the independence and ethics requirements appropriate? Are there any practical challenges associated with the revised amendments? If so, what are they, and how could the proposed requirements be revised to address the challenges?

17. On the face of it, the proposed revised requirement for auditors to understand the other auditor's *process* for determining compliance with independence and other ethical requirements and the other auditor's experience in applying them, may seem more robust than

a simple requirement to understand the other auditor's knowledge of the requirements. Large firms routinely require auditors to look at both process and the outcome. But what matters more? The fact that the other auditor has been through a process, or whether the other auditor actually understands and has applied the requirements? It is easier for PCAOB inspectors to challenge process than it is to challenge lead auditor judgements regarding other auditor compliance with ethical requirements but the latter is important. Lead auditor understanding of other auditors' supervisory staff compliance with independence and other ethical requirements on an individual basis is important. Lead auditors need to know, for example, if senior staff at the other auditor have been disciplined by local regulators.

18. Requiring auditors to *understand* the other auditor's knowledge can be seen as a more far-reaching requirement. It can be interpreted as going further than the broader, more superficial requirement to understand process. This is the position firms believe they are in now. Lead auditors seek to understand compliance using questionnaires, following up on answers that do not make sense. **Might it be better to look at process as a means to an end, rather than an end in itself, and to marry the original proposals with the proposed revisions by requiring lead auditors to understand the other auditor's process for determining compliance and experience in applying the requirements *in order to* understand the other auditor's knowledge and application of the requirements?**

19. The regulatory approach to independence and other ethical requirements is critical. The PCAOB states that it does not 'currently' intend to prescribe how firms go about understanding the other auditor's process but then, by implication, goes on to describe what it might prescribe, i.e. obtaining a written description of the process and results thereof, or through inquiry and performing appropriate follow-up procedures to address gaps. If this is what the PCAOB wants lead auditors to do, it should say so in the standard itself rather than leaving it to PCAOB inspectors to make this clear. The PCAOB also describes factors affecting the necessary effort to obtain the understanding of the other auditor's process and experience, such as the lead auditor's existing knowledge. Again, there seems to be little reason why this should not be included as a note in the standard itself.

20. The proposed revised requirement to obtain a representation from the other auditor *that it is, or is not, in compliance* with independence and other ethical requirements, and if not to obtain a description of the nature of any non-compliance is clear.

21. However, the proposed revised requirement for lead auditors to obtain a written description from each other auditor regarding relationships with the entity or persons in financial reporting oversight roles that may reasonably be thought to bear on independence is more problematic. The significance of a relationship between auditors and persons in financial reporting oversight roles at a component may be different to such a relationship at group level and we do not believe that there is any need to identify such relationships on a blanket basis *unless* the risk assessment indicates otherwise. Again, the risk is that auditors will obtain the information, at a cost, for inspection purposes only and that it will be of little relevance to the 'real' audit.

22. The proposals state that the Board has preliminarily decided not to allow 'reliance' on networks in determining the other auditor's compliance with independence and other ethical requirements. This statement needs some unpacking and we urge the PCAOB to open up a more nuanced and mature discussion of this important area. The IAASB's project on group audits is looking very carefully at this area and we urge both bodies to engage both with each other, and with audit firms on this issue.

23. Even firms that have tightly integrated networks and robust quality controls do not allow auditors to assume that because another network firm has performed the audit, the audit approach taken is appropriate, the audit evidence obtained can be taken at face value and compliance with ethical requirements can be taken as read.

24. We understand that the IAASB is currently intending to acknowledge the existence of network wide controls in group audits, and to require lead auditors to take a robust approach to obtaining appropriate evidence regarding the design, implementation and operating effectiveness of network controls in situations in which a modified audit approach is proposed on the basis that network controls are operating effectively. We urge the PCAOB to engage in these discussions rather than to close the issue.

25. In our response to the original 2016 proposals dated we do not use the word 'reliance' in the context of networks. We stated, and we re-iterate the following:

    The overall impression given reading the proposals is that that the PCAOB regards firm and network-wide quality controls as untrustworthy, and believes that lead auditors should trust no-one unless they have no choice, and that they should seek to perform the work themselves wherever possible. This approach seem to ignore, a number of structural issues that standard-setting cannot address. We urge the PCAOB to take a more nuanced and intelligent approach to these difficult issues. Investments made by network firms to improve common standards should enable lead auditors to make some use of the overall systems of quality control within such networks.

    The development and application of quality control standards, both within firms and across networks, driven to a great extent by audit regulators, has been critical in enhancing audit quality the last fifteen years. Lead auditor work on the quality control standards of other auditors is key to the approach to many if not most large group audits. We do not question the need for improvement in the application of those standards, but we are perplexed by these proposals because while they acknowledge the importance of quality controls, they appear to dismiss their value almost entirely by effectively, if not explicitly, encouraging auditors to bypass auditors who co-ordinate other auditors by requiring direct communicating with lower tier auditors

26. At the very least, the standard itself should contain the PCAOB's note to the effect that lead auditors may be able to access more readily information about network affiliates than non-affiliated firms.

Q4: Are the proposed amendments relating to the knowledge, skill, and ability of the other auditor, revised by this release, appropriate? Are there any practical challenges associated with the revised amendments? If so, what are they, and how could the proposed requirements be modified to address the challenges?

27. We agree that merely obtaining a statement from a network firm that it complies with network-wide qualification requirements for staff assigned to PCAOB audits would be inadequate and that it is important for lead auditors to understand situations in which other auditors had been required to make improvements as a result of local regulatory inspections, for example. In practice, gaining an understanding of the knowledge, skill and ability of individuals who assist in planning or supervision is commonplace as are inquiries regarding other auditor policies and procedures related to training of staff working on PCAOB audits and their assignment thereto. However, this can and should be dealt with through the summary memorandum rather than as a separate exercise and we note in our main points above that summary memoranda are in practice 'cascaded up' through reporting hierarchies and that requiring lead auditors to obtain individual memoranda from other auditors will be performed as a compliance exercise only.

Q5: Are the proposed new addition to AS 1015 and revision to AS 1201 relating to the other auditors' responsibility appropriate and clear? Is it clear that AS 1015 already applies to referred-to auditors that perform audits under PCAOB standards?

Q6: Are the proposed new additions to AS 2101.B2 appropriate and clear? Also, is it clear that the necessary level of detail of the other auditor's audit documentation that the lead auditor obtains and the necessary extent of the lead auditor's review according to requirements in proposed Appendix B of AS 1201 are scalable based on the factors in the existing standard regarding the necessary extent of supervision?

28. We refer to our answer to Q2, above.

29. We agree with two new notes clarifying that the level of detail in the other auditor's documentation reviewed should be determined with reference to the necessary extent of supervision. While we agree that in general, review should amount to more than discussions, it would be helpful for the standard itself to note that, as the PCAOB itself acknowledges, technology can be used to review documentation. This is often an efficient supplement or in some cases alternative to visiting the other auditors.

30. Documentation of visits to other auditors is important in terms of the purpose of the visit, what inquiries and other work are planned, what is actually performed, the extent to which that work is sufficient to achieve the objectives of the visit, necessary follow-up work and conclusions.

31. We also re-iterate the following point made in our response to the 2016 proposals:

    Auditors note that the first question regulators often ask are about visits to group companies and other auditors. Visits to other auditors or the entities they audit can be wasted if the purpose of the visit is not clearly thought out, the visit is poorly managed, if it is too short, undertaken for the sake of appearances, and if those sent are poorly briefed or are insufficiently experienced to deal with unprepared or hostile hosts. But such visits are often performed in the belief that regulators are less likely to question such an approach, than they are a decision to review files, which is too often interpreted as a cost management exercise.

Q7: Are the revised proposed requirements for situations in which the lead auditor directs another auditor to perform supervisory procedures with respect to a second other auditor on behalf of the lead auditor clear? If not, how should the revised proposed requirements be revised?

32. In the context of multi-tiered audits the PCAOB acknowledges concerns regarding the bypassing of first other auditors and requiring lead auditors to communicate directly with second other auditors. In our response to the 2016 proposals, we argued forcefully, as the PCAOB acknowledges, that first other auditors are often better positioned to make those communications because they understand local operations and controls better than the lead auditor. We are therefore pleased that the PCAOB is proposing to permit a first other auditor to make certain communications to a second other auditor in a multi-tiered audit, as long as the lead auditor receives adequate information about the communications and retains a copy thereof, including the second other auditors' summary memorandum. The work of the first other auditor in relation to the second other auditor should mirror the work of the lead auditor in relation to the first other auditor.

33. All of that said, while the revised proposed requirements are clear, we do not believe that they go far enough. There is still scope for better use of first other auditors in multi-tiered audits without compromising audit quality. The revised proposed requirement for lead auditors to obtain, review and retain a summary memorandum from second other auditors through the first other auditor, rather than directly from the second other auditor is a step forward but it is still far from reflective of the manner in which companies and their auditors actually operate.

34. We fully acknowledge the need for lead auditors to engage with second other auditors directly without reference to first other auditors. In any business, those with high level responsibilities

must attend to the reports of those they appoint to manage business activities but from time to time they must also 'walk the floor', to understand what is actually happening and to encourage diligence in reporting. But if the need to verify is paramount and the controls designed to form a basis for trust are never tested, such controls become redundant. There is little point in appointing a layer of middle management if senior management ignores it and continues to manage the business as if it was not there.

35. It is impossible to control everything from the top. The revised requirements would be further improved if they acknowledged more clearly the critical role of the risk assessment that is, in practice, carried out at all levels. The PCAOB should acknowledge properly the ability of first other auditors to effectively supervise and monitor second (and more) other auditors to avoid lead auditors obtaining information of limited value to the audit.

36. Lead auditors will in practice make use of the lines of responsibility and reporting in multi-tiered audits in performing their risk assessments and determining their responses. They will focus on the summary memoranda obtained from first other auditors, which in turn will cover the work of second other auditors. Summary memoranda are in practice 'cascaded up' through reporting hierarchies. If the PCAOB also requires lead auditors to obtain, review and retain summary memoranda from second other auditors, they will of course do so, but as a compliance exercise and in a perfunctory manner, because that is what the PCAOB expects, and what PCAOB inspectors will seek to inspect.

Q8: Is the revision to the proposed standard relating to the division of responsibility when the company and its business unit use different reporting frameworks appropriate and clear?

37. We note in our main points above our belief that a better way of dealing with divided responsibility would be to adopt the approach taken under the ISAs and in advanced jurisdictions elsewhere in the world, by requiring the same work effort for lead auditors in all situations, regardless of whether responsibility is divided. While it may sometimes be difficult for lead auditors to supervise the work of other firms, and a specific audit approach may be impracticable in a specific area for a specific entity, it is rarely if ever wholly 'impracticable' for lead auditors to supervise other auditors.

38. The approach of regulators is critical in this area, and the SEC applies a high hurdle for analogous impracticability tests and applies judgement as appropriate to specific areas in individual cases. There is no reason why the PCAOB, as a mature regulator, should not do the same.

39. The PCAOB would better serve US investors if it raised the standard for divided responsibility to that required under the ISAs. The PCAOB should not continue to support this differential approach, still less extend it to situations in which different financial reporting frameworks are in use.

Q9: Is it clear how the proposed amendments and new standard (as revised by this release) relate to other amendments to auditing standards proposed or adopted by the Board since the 2016 Proposal?

Q 10: Comment is requested on the matters discussed in this section. Would any revisions the Board is considering for adoption affect the scalability of PCAOB standards in this area? Would any have a significant effect on the competitiveness of smaller audit firms? Would the revisions significantly change the costs and benefits associated with the proposed changes discussed in the 2016 Proposal? Are there any unintended consequences that the Board should consider? Are there any other matters not addressed in this release the Board should consider in its economic analysis?

40. We note elsewhere in this response our support for:

    - the removal of the proposed requirement for lead auditors to record a description of other auditor documentation reviewed but not retained, and of the requirement for certain communications to be made directly between lead auditors and second other auditors, bypassing first other auditors;

    - secondees from other accounting firms and employees of shared service centres working under the lead auditor's guidance and control being be treated as employees of the lead auditor's firm and not as other auditors;

    - the acknowledgement that summary memoranda are widely used in practice and that a good audit trail is important in any audit involving more than one auditor, but that the content of summary memoranda varies extensively depending on circumstances.

41. All of these improvements will be of disproportionate benefit to smaller audits. However, these improvements do not go far enough and the PCAOB can and should permit lead auditors to make much better use of first other auditors in multi-tiered audits, not least because attempts to control everything from the top are likely to fail.

42. In this response, we point out in a number of areas that under the proposed revised requirements, auditors are likely to obtain documentation for inspection and compliance purposes only. That documentation comes at a cost. It is largely irrelevant to the ‘real’ audit, clutters the audit file and draws attention away from the real risks assessed. This is bad for all audits but it particularly deleterious to smaller audits that have no slack built into them to accommodate such distractions.