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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

PCAOB Rulemaking Docket Matter No. 042: ***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***

Dear Ms. Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2017-005, *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* (referred to as the proposed amendments and the proposed standard, respectively, and collectively as the Supplemental Request for Comment).

The Board has requested public comment on the Supplemental Request for Comment that is intended to improve audit quality and investor protection through enhancements to the current requirements related to the lead auditor's responsibilities concerning 1) the supervision of other auditors and 2) referred-to auditors. We continue to support the Board's initiative to further strengthen audit quality and investor protection with respect to audits that involve other auditors and referred-to auditors.

Overview

KPMG appreciates the PCAOB's efforts to acknowledge and respond to the comments it received in relation to Release No. 2016-002, *Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard – Dividing Responsibility for the Audit with Another Accounting Firm* (the 2016 Proposal), through its Supplemental Request for Comment. We continue to support the Board's goal to provide a more uniform, risk-based approach to supervision in audits that involve other auditors and agree further considerations and amendments to Auditing Standard (AS) 2101, *Audit Planning*, and AS 1201, *Supervision of the Audit Engagement*, are necessary to achieve this goal.

The Supplemental Request for Comment clarified certain items in the 2016 Proposal about which we had concerns, particularly with respect to the criteria for sufficiency of participation as the lead auditor and the other auditor's responsibility to perform work with due professional care. However, we offer the following comments on the proposed amendments and proposed standard where further clarification and guidance may be warranted, as well as observations regarding anticipated challenges and costs relative to anticipated benefits.

Definitions

We note that the release text in the Supplemental Request for Comment indicates that “secondees from other accounting firms and employees of shared service centers working under the lead auditor’s guidance and control (as with other individuals who work in the role of firm employees) should be treated as employees of the lead auditor’s firm.”[1] We recommend that the Board include this concept in the final amendments and final standard as part of the definition of lead auditor. We believe this information is essential to facilitate consistent interpretation and application of this term from the onset of its introduction by the proposed amendments and proposed standard.

Similarly, we recommend that the release text noted below from footnote 20 of the Supplemental Request for Comment be explicitly incorporated into paragraph .B4 of AS 2101:

> The definition of "other auditor" includes both a firm and individuals from that firm. As a practical matter, this requirement would typically be applied at the firm level because the other auditor firm would typically have both the processes for determining compliance with PCAOB independence and ethics requirements and SEC independence requirements and some level of experience in applying those requirements. This requirement would be applied at the individual level for participating persons who are not part of a firm.

This addition would provide clarity regarding the level at which the lead auditor applies the requirement and would reduce the likelihood of misinterpretation (specifically, for example, by misapplication of the requirement at the individual level when the participant is a member of a firm). Misinterpretation of this nature could result in the lead auditor performing procedures beyond the intended scope of the proposed amendments, which would result in increased costs and may harm audit quality as a result of incorrectly focused efforts. We have additional observations concerning paragraph .B4 of AS 2101, which are noted below in the “Other auditor’s compliance with independence and ethics requirements” section of this letter.

Determination to serve as lead auditor

We believe the sufficiency of participation in the audit by the lead auditor should be a risk-based assessment with collective consideration of quantitative and qualitative factors. Accordingly, we agree with the proposed revision to paragraph .B2b of AS 2101 that enables the lead auditor to consider qualitative criteria, such as the importance of the locations or business units for which the lead auditor performs procedures, in the determination of sufficiency of participation.

[1] Supplemental Request for Comment, page 34.

However, we do not believe the addition of the following sentence to the end of paragraph .B2 of AS 2101 is needed:

> "In addition, the participation of the engagement partner's firm to serve as lead auditor ordinarily is not sufficient if the referred-to auditors, in aggregate, audit more than 50 percent of the company's assets or revenues."

As noted by the Board, the Financial Reporting Manual of the SEC's Division of Corporation Finance already provides similar guidance, and therefore we believe including the above threshold in the final amendments would be repetitive and is unnecessary.

Other auditor's compliance with independence and ethics requirements

We believe that requiring the lead auditor to gain an understanding of the other auditor's process for determining compliance with SEC independence requirements and PCAOB independence and ethics requirements and their experience in applying those requirements presents several challenges and other implications that should be considered by the Board in the final amendments. Such challenges and implications include the following:

- *Capabilities of lead auditor engagement team* – We are concerned that the requirement to obtain an understanding of the other auditor's process for and experience with determining compliance with independence and ethics requirements appears, from the release language, to include the responsibility to identify gaps that may exist in the other auditor's process and evaluate the impact of those gaps on the audit. This would greatly expand the lead auditor engagement team's procedures in this area and may require the specialization and expertise of others outside of the team, such as those experienced in the evaluation of firm-level processes and controls over SEC independence requirements and PCAOB independence and ethics requirements. Therefore, we are concerned that the lead auditor engagement partner may not have the ability or necessary knowledge to determine the sufficiency of or identify issues in the other auditor's compliance process to the extent described in the proposed amendments.

- *Scalability of procedures* – As proposed, the extent of procedures required to determine compliance with the SEC independence requirements and the PCAOB independence and ethics requirements is the same across all other auditors regardless of whether or not the other auditor is a (i) PCAOB registered accounting firm, or (ii) member firm of the lead auditor accounting firm. Network member firms typically implement systems of quality control to comply with local professional standards and incremental procedures that are required as a condition of being a member firm of the network. In addition, PCAOB registered accounting firms are required to comply with the PCAOB's quality control standards. The other auditor's adoption of these commonly understood requirements for systems of quality control should be a factor the lead auditor may consider when assessing the extent of procedures required to determine the other auditor's compliance with the independence and ethics requirements.

- *Increased costs* – This aspect of the proposed amendments would result in a significant increase in costs for audit firms and therefore issuers due to: (i) the lead auditor performing additional procedures, beyond those required by the current auditing standards, to gain an understanding of each other auditor's process and to determine their compliance with the SEC independence requirements and PCAOB independence and ethics requirements to the extent proposed; and (ii) duplication of procedures over the same other auditor across multiple engagements (e.g., an engagement team from Firm A that serves as lead auditor for Entity X would need to determine compliance by Other Auditor 1 with the SEC independence requirements and the PCAOB independence and ethics requirements, and a separate engagement team from Firm A that serves as lead auditor for Entity Y would also need to perform those same procedures if Other Auditor 1 participated in that audit). The corresponding benefit from an audit quality perspective of these increased costs to investors and registrants is unclear.

As expressed in our previous comment letter[2], we believe that the proposed amendments should allow the lead auditor to rely on the other auditor's system of quality control in certain situations. Instead, the proposed amendments require the lead auditor to gain an understanding of the other auditor's process to determine its compliance with SEC independence requirements and PCAOB independence and ethics requirements. PCAOB registered accounting firms are required to establish and apply a quality control system comprised of elements focused on, but not limited to, independence, objectivity, and the acceptance and continuance of clients and engagements. In addition, we believe that network member firms typically establish a system of quality control that complies with a globally recognized set of quality control standards. For example, KPMG member firms are required to comply with International Standard on Quality Control 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements* (ISQC 1), and to implement quality controls that fulfill provisions of Rule 2.01(d)(4) of Regulation S-X. We believe that the representation of a PCAOB registered accounting firm that their system of quality control is in compliance with the PCAOB quality control standards or a globally recognized set of quality control standards used by the network member firm that is comparable to the PCAOB's quality control standards should be sufficient for purposes of the lead auditor's assessment of the other auditor's compliance with SEC independence requirements and PCAOB independence and ethics requirements.

Therefore, we recommend the Board revise the proposed requirement at paragraph .B4b of AS 2101 to allow the receipt of such written representation to be independently sufficient in instances where the other auditor is a PCAOB registered accounting firm or a network member firm with a system of quality control based on a globally recognized set of quality control standards. If information comes to the attention of the lead auditor that the written representation is false, inaccurate, or otherwise cannot be relied upon, we agree that the lead auditor should perform additional procedures to determine the effect of such information on the independence of the

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[2] KPMG comment letter on PCAOB Rulemaking Docket Matter No. 042, July 29, 2016.

other auditor. Similarly, in those situations where the other auditor is not a PCAOB registered accounting firm nor a network member firm of the lead auditor (and therefore subject to standardized requirements for its system of quality control), we agree that procedures designed to allow the lead auditor to gain an understanding of the other auditor's process for determining compliance with the SEC independence requirements and PCAOB independence and ethics requirements should be required.

In addition, the requirement in paragraph .B4b.(2) of AS 2101 could be interpreted to be overly broad in that it can be read to imply that <u>any</u> violation of the SEC independence requirements or PCAOB independence and ethics requirements (e.g., a violation that relates to another audit client) would necessitate the other auditor to represent that it is not in compliance, and to provide a description of the nature of the non-compliance. Such a requirement would likely result in issues with respect to the disclosure of client confidential information. We believe the representation as to compliance, and the description of the nature of any non-compliance, should focus solely on the specific audit client for which the accounting firm is serving as an other auditor.

Other auditor's knowledge, skill, and ability

Although we agree with the Board that the lead auditor should determine the necessary extent of supervision of the other auditors, we do not support the proposed revisions in paragraph .B6a of AS 2101 requiring the lead auditor to inquire of the other auditor's policies and procedures related to the assignment and training of individuals who work on audits conducted under PCAOB standards. The lead auditor engagement team may not be qualified to sufficiently evaluate another firm's work assignment procedures or training curriculum. An engagement partner will typically rely on his/her own firm's system of quality control with respect to the engagement team's knowledge, skill, and ability, particularly the policies and procedures over assignment and training of individuals. Furthermore, the lead auditor gains more valuable and representative information regarding the other auditor's knowledge, skill, and ability through the interactions and prior experience with the other auditor, rather than through inquiring about the other auditor firm's policies and procedures over work assignments and training curriculum. Therefore, such an inquiry and response concerning the other auditor's assignment and training policies and procedures would unlikely provide a meaningful basis for the lead auditor to conclude on the other auditor's knowledge, skill, and ability. The requirement to make inquiries of the other auditor about its policies and procedures for 1) the assignment of individuals to audits conducted under PCAOB standards and 2) training curriculum for individuals who perform procedures on audits conducted under PCAOB standards, as proposed, would result in increased costs, and the benefit to audit quality and investor protection is not clear.

Further, similar to the above requirement to determine the other auditor's compliance with independence and ethics requirements, consideration of a firm's system of quality control, whether established in accordance with PCAOB quality control standards or a globally recognized set of quality control standards such as ISQC 1, should be an element in this assessment of the other auditor. An accounting firm's system of quality control incorporates elements relating to personnel management, engagement management, and monitoring. We recommend the Board incorporate reliance on a firm's system of quality control to complement the proposed amendments with pre-existing quality control standards. We also recommend the Board consider revising the proposed requirement in paragraph .B6a of AS 2101 to require that the lead auditor obtain a written representation from the other auditor stating compliance with the personnel management aspects (i.e., work assignments and training curriculum) of the PCAOB's quality control standards.

Regardless of whether the Board decides to allow reliance on a PCAOB registered accounting firm's or a network member firm's system of quality control, we believe the Board should establish the minimum requirements that should be met to demonstrate the other auditor's knowledge, skill, and ability as intended by the Board's proposed amendments.

AS 1206

Although the Board clarified that procedures to evaluate the referred-to auditor's qualifications were limited to inquiry and other information obtained during the course of the audit[3], the proposed standard uses language that the "lead auditor determines … that the referred-to auditor knows the relevant requirements of the applicable financial reporting framework, standards of the PCAOB, and financial reporting requirements of the SEC"[4], which appears to be the same objective in paragraph .B6b.(2) of AS 2101. This could be interpreted to mean that procedures beyond inquiry might be required for the lead auditor to make a reasonable assessment of the referred-to auditor's qualifications, which we do not believe is necessary given the division of responsibility. Because we do not believe the Board intended for the extent of procedures to be consistent for other auditors and referred-to auditors, we request the Board add a note to the final standard that would explicitly indicate that there is a distinction in the procedures to be performed by the lead auditor to determine the sufficiency of the other auditor's and referred-to auditor's qualifications.

Effective Date

Substantial changes to our audit methodology will be required to effectively implement the final amendments and final standard, if they are representative of what is reflected in the Supplemental Request for Comment. It will be necessary to issue policies and procedures and to train our audit professionals, including those throughout our network member firms who participate in audits conducted under PCAOB standards. Further, planning and coordination of the audit by the lead auditor with the other auditors typically occurs early in the audit planning phase (e.g., March for December fiscal year-end engagements) and sufficient time will be necessary for lead auditor engagement teams to successfully incorporate the new requirements into their audit plan. Therefore, we recommend that the effective date of the final amendments and final standard be

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[3] Supplemental Request for Comment, page 26.

[4] Proposed AS 1206.06b, Supplemental Request for Comment, page A3-3.

for audits of fiscal years beginning two years after the year of the SEC's approval of the final amendments and final standard.

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We appreciate the Board's careful consideration of our comments and observations, and support the Board's efforts to increase accountability of the lead auditor and improve audit quality and investor protection. If you have any questions regarding our comments included in this letter, please do not hesitate to contact Matt Doyle ((212) 954-2187) or mrdoyle@kpmg.com) or Rob Chevalier ((212) 909-5067 or rchevalier@kpmg.com).

Very truly yours,

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cc:

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