

# CHAPTER 1

## OVERVIEW

### 100 BACKGROUND

100.1 For many years, auditors had traditionally conducted their engagements in accordance with generally accepted auditing standards developed by the American Institute of Certified Public Accountants (AICPA). Auditors of publicly-traded companies have also had to follow the additional rules of the SEC. However, this changed dramatically in 2002 with the passage of the Sarbanes-Oxley Act and the subsequent establishment of the Public Company Accounting Oversight Board (PCAOB).

100.2 The *Sarbanes-Oxley Act of 2002* (SOX) was passed in response to a growing number of financial scandals that started with Enron in the fall of 2001. These financial scandals eventually led to the collapse of some large public companies, including Enron and WorldCom (owner of telecommunications giant MCI). Their CEOs and other financial executives were convicted of criminal fraud and received prison sentences. Stockholders and creditors lost billions when these companies failed. In addition, the Enron and WorldCom collapses led to the failure of Andersen, one of the world's largest accounting firms. Congress felt compelled to act and responded with the *Sarbanes-Oxley Act of 2002*.

#### **Sarbanes-Oxley Act of 2002**

100.3 The portion of SOX that has the greatest impact on public company auditors is Section 404, which deals with management's assessment of internal controls. However, there are several sections that are also important to audit firms. Exhibit 1-1 summarizes some of the more important sections of SOX.

#### **Exhibit 1-1**

#### **Highlights of the Sarbanes-Oxley Act of 2002**

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| Section 101 | This section establishes the Public Company Accounting Oversight Board (PCAOB), which is the organization responsible for overseeing the audits of public companies. (Public companies are referred to as "issuers" in SOX. The term <i>issuer</i> is defined in the SEC rules and generally refers, among other organizations, to companies whose securities are registered under the Securities Exchange Act of 1934.) |
| Section 102 | This section establishes the requirement for accounting firms to register with the PCAOB in order to audit public companies.   |

Section 103	Section 103 has several important components, including the requirement that auditors keep their audit workpapers for seven years. In addition, each audit report must have a concurring review performed before it is issued.
Section 104	This section establishes the requirement for the PCAOB to inspect each large registered accounting firm (those with more than 100 public company audit clients) annually and each small firm (those with 100 or fewer clients) at least every three years.
Section 201	Section 201 defines nonaudit services that public company auditors cannot provide without impairing their independence. These services are further discussed in SEC Rule 2-01 of Regulation S-X. See section 201 of this <i>Guide</i> for more information.
Section 202	This section requires preapproval of a firm's audit and nonaudit services by the client's audit committee.
Section 203	This section specifies partner rotation schedules for public company auditors. Generally, a lead and concurring partner can serve on a client's audit engagement team for no more than five years in a row. Partner rotation is addressed in more detail in SEC Rule 2-01 of Regulation S-X. See section 201 of this <i>Guide</i> for more information.
Section 401	This section requires that financial statements reflect all material correcting adjustments proposed by the auditor.
Section 404	Section 404 is generally considered to be the most challenging section of SOX. It requires a company's management to assess its internal control over financial reporting, and it requires the auditor to attest to and report on management's assessment. The auditor must assess and report on management's assessment as part of the audit of the financial statements. (However, the discussion beginning at paragraph 100.4 details amendments to Section 404.)

**Note:** This exhibit is not a complete overview of SOX, but mentions some of the more important aspects (in the authors' opinion) from an auditor's perspective.

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### Other Legislation Affecting Sarbanes-Oxley

100.4 In recent years, several other Acts have been signed into law by the President that amend key provisions of the *Sarbanes-Oxley Act of 2002*. In addition to the amendments of SOX, these Acts introduced other legislation that impact issuers and their auditors.

100.5 **Dodd-Frank Act.** The *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act), which became effective on July 21, 2010, exempts nonaccelerated filers from complying with Section 404(b) of the *Sarbanes-Oxley Act of 2002* requiring an independent auditor's attestation on the effectiveness of an entity's internal control over financial reporting. The Act also contains numerous other provisions that affect registrants and their auditors.

100.6 Some of the provisions of the Act affecting SEC rule-making or studies include:

- Requires the SEC to conduct a study on how Sarbanes-Oxley Section 404(b) compliance burdens can be reduced for companies with market capitalizations between \$75 million and \$250 million.
- Requires a nonbinding shareholder vote on compensation for named executive officers at least once every three years (say-on-pay). In addition, a nonbinding shareholder vote is required on compensation for named executive officers in connection with acquisitions, mergers, sales, and similar transactions unless otherwise included in the general say-on-pay shareholder vote.
- Requires public companies to have compensation committees that include only independent directors.

- Expands disclosures in the annual proxy statement on executive compensation, including information on the median annual total compensation for all employees and the annual compensation of the CEO, as well as a ratio of such amounts.
- Requires the SEC to issue rules for companies to establish policies to recover excess compensation paid to executive officers in the event of financial reporting restatements due to noncompliance with accounting standards.
- Unless specific instructions are provided by the owner, prohibits brokers from voting shares for director elections, executive compensation, or other significant matters.
- Authorizes the SEC to issue rules that permit shareholders to nominate directors in the proxy, subject to ownership thresholds.
- Requires the disclosure in the proxy materials on why the company has elected to either combine or separate the roles of board chairman and CEO.
- Amends the Securities Act of 1933 to allow the SEC to sue a party that “knowingly or recklessly provides substantial assistance to another person” in violating the Securities Act or related rules and regulations. This changes the level of liability from a “knowingly” standard to a “knowingly or recklessly” standard.

Recent SEC activities relating to some of these provisions are discussed in section 1003.

100.7 Section 982 of the Dodd-Frank Act authorizes the PCAOB to establish standards for registered public accounting firms relating to audits of broker-dealers for reports included in filings with the SEC. On July 31, 2013, the SEC issued a final rule that, among other things, requires audits of all broker-dealers (including *nonpublic* broker-dealers) to be conducted in accordance with the standards of the PCAOB. Prior to implementing the requirements set forth by the SEC final rule, audits of nonpublic broker-dealers have been performed in accordance with GAAS. The final rules also require broker-dealers to file new reports with the SEC. As further discussed beginning in paragraph 100.22, in October 2013, the PCAOB approved two attestation standards that provide requirements for examining or reviewing the assertions in the broker-dealer’s compliance or exemption report filed in compliance with SEC reporting rules. Also, AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements*, applies whenever the auditor is engaged to audit and report on supplemental information that accompanies the audited financial statements. The supplemental information includes the supporting schedules required by the SEC’s broker-dealer financial reporting rule or other audited supplemental information included in SEC filings, whether required by another regulatory body or voluntarily submitted by the issuer. A comprehensive discussion of audits of brokers and dealers is beyond the scope of this *Guide*. *PPC’s Practice Aids for Audits of Broker-Dealers* provides additional detailed information on such audits.

100.8 Section 1003 discusses recent developments pertaining to the Dodd-Frank Act, including SEC, federal congressional, and executive branch actions that challenge aspects of the law and its continued implementation.

100.9 **JOBS Act.** The *Jumpstart Our Business Startups Act* (JOBS Act), which became effective on April 5, 2012, amends Section 404(b) of the Sarbanes-Oxley Act to eliminate the requirement for an auditor’s attestation on the effectiveness of an entity’s internal control over financial reporting for companies defined as an “emerging growth company.” The JOBS Act also provides for the delay of the implementation of newly adopted accounting and auditing standards in certain respects, as well as additional matters, for emerging growth companies. The JOBS Act, including recent developments, is discussed more fully beginning with paragraph 905.77.

## PCAOB Standards

100.10 As noted in Exhibit 1-1, Section 101 of SOX established the PCAOB, which operates under the general oversight of the SEC, to regulate the audits of public companies. Among other requirements, SOX assigns the following responsibilities to the PCAOB:

- a. Registering public accounting firms that provide audit services to public companies.
- b. Establishing or adopting auditing, quality control, ethics, independence, and other standards for the audits of public companies.
- c. Conducting periodic inspections of registered public accounting firms to ensure that they are complying with SOX, PCAOB rules and standards, and federal securities laws.
- d. Conducting investigations and disciplinary proceedings, and applying sanctions, as needed.

100.11 Initially, to provide continuity, the PCAOB adopted the generally accepted auditing standards of the AICPA that existed as of April 16, 2003, as interim standards for audits of public companies. PCAOB Release No. 2003-006, which established interim auditing and related professional practice standards, consists of the following five rules:

- Interim auditing standards (Rule 3200T).
- Interim attestation standards (Rule 3300T).
- Interim quality control standards (Rule 3400T).
- Interim ethics standards (Rule 3500T).
- Interim independence standards (Rule 3600T).

In addition to the AICPA standards that the PCAOB adopted as interim standards, the PCAOB had adopted 18 auditing standards, all of which have been approved by the SEC.

100.12 Similar to other standard-setters like the AICPA and FASB, the PCAOB determined that it needed to reorganize its existing interim and subsequently-issued auditing standards into a topical structure with an integrated numbering system. Adopted on March 31, 2015, PCAOB Release 2015-002, *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, implemented such a structure. The reorganization scheme was intended to enhance the usability of auditing standards by presenting the standards in a logical order that generally follows the flow of the audit process.

100.13 **Organization of Auditing Standards.** The PCAOB auditing standards are organized by topic into the following categories:

- *General Auditing Standards.* Standards on broad auditing principles, concepts, activities, and communications.
- *Audit Procedures.* Standards for planning and performing the audit and obtaining evidence.
- *Auditor Reporting.* Standards relating to the auditors' reports.
- *Matters Relating to Filings under Federal Securities Laws.* Standards on auditors' responsibilities relating to SEC filings for securities offerings and reviews of interim financial information.
- *Other Matters Associated with Audits.* Standards relating to work performed in connection with broker-dealer audits.

Subcategories exist for each of the categories to further organize similar topical standards. For example, under "General Auditing Standards," there is a subcategory, "Auditor Communications," to organize topical standards relating to communications with audit committees and communications about control deficiencies.

100.14 The integrated referencing system uses an “AS” instead of an “AU” preface as seen in the PCAOB interim auditing standards. Also, each auditing standard is assigned a four-digit number based on its general category and subcategory grouping. For example, AS 3101, *Reports on Audited Financial Statements*, is categorized under the subcategory 3100—*Reporting on Audits of Financial Statements*, and further categorized under the broad category of “Auditor Reporting.” The PCAOB Release notes that the reference system differs from that used by the AICPA and IAASB to avoid potential confusion. Appendix 1 to the Release illustrates the organization framework in its entirety. Exhibit 1-2 shows a mapping of the previous standards to the current framework.

### Exhibit 1-2

#### PCAOB Auditing Standards

<b>General Auditing Standards</b>	
1000 General Principles and Responsibilities	
AS 1001	Responsibilities and Functions of the Independent Auditor
AS 1005	Independence
AS 1010	Training and Proficiency of the Independent Auditor
AS 1015	Due Professional Care in the Performance of Work
1100 General Concepts	
AS 1101	Audit Risk
AS 1105	Audit Evidence
AS 1110	Relationship of Auditing Standards to Quality Control Standards
1200 General Activities	
AS 1201	Supervision of the Audit Engagement
AS 1205	Part of the Audit Performed by Other Independent Auditors
AS 1210	Using the Work of a Specialist
AS 1215	Audit Documentation
AS 1220	Engagement Quality Review
1300 Auditor Communications	
AS 1301	Communications with Audit Committees
AS 1305	Communications About Control Deficiencies in an Audit of Financial Statements
<b>Audit Procedures</b>	
2100 Audit Planning and Risk Assessment	
AS 2101	Audit Planning
AS 2105	Consideration of Materiality in Planning and Performing an Audit
AS 2110	Identifying and Assessing Risks of Material Misstatement
2200 Auditing Internal Control Over Financial Reporting	
AS 2201	An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

2300 Audit Procedures in Response to Risks—Nature, Timing, and Extent	
AS 2301	The Auditor's Responses to the Risks of Material Misstatement
AS 2305	Substantive Analytical Procedures
AS 2310	The Confirmation Process
AS 2315	Audit Sampling
2400 Audit Procedures for Specific Aspects of the Audit	
AS 2401	Consideration of Fraud in a Financial Statement Audit
AS 2405	Illegal Acts by Clients
AS 2410	Related Parties
AS 2415	Consideration of an Entity's Ability to Continue as a Going Concern
2500 Audit Procedures for Certain Accounts or Disclosures	
AS 2501	Auditing Accounting Estimates
AS 2505	Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments
AS 2510	Auditing Inventories
2600 Special Topics	
AS 2601	Consideration of an Entity's Use of a Service Organization
AS 2605	Consideration of the Internal Audit Function
AS 2610	Initial Audits—Communications Between Predecessor and Successor Auditors
2700 Auditor's Responsibilities Regarding Supplemental and Other Information	
AS 2701	Auditing Supplemental Information Accompanying Audited Financial Statements
AS 2705	Required Supplementary Information
AS 2710	Other Information in Documents Containing Audited Financial Statements
2800 Concluding Audit Procedures	
AS 2801	Subsequent Events
AS 2805	Management Representations
AS 2810	Evaluating Audit Results
AS 2815	The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"
AS 2820	Evaluating Consistency of Financial Statements
2900 Post-Audit Matters	
AS 2901	Consideration of Omitted Procedures After the Report Date
AS 2905	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report
<b>Auditor Reporting</b>	
3100 Reporting on Audits of Financial Statements	
AS 3101	The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion



AS 3105	Departures from Unqualified Opinions and Other Reporting Circumstances
AS 3110	Dating of the Independent Auditor's Report
3300 Other Reporting Topics	
AS 3305	Special Reports
AS 3310	Special Reports on Regulated Companies
AS 3315	Reporting on Condensed Financial Statements and Selected Financial Data
AS 3320	Association with Financial Statements
<b>Matters Relating to Filings Under Federal Securities Laws</b>	
AS 4101	Responsibilities Regarding Filings Under Federal Securities Statutes
AS 4105	Reviews of Interim Financial Information
<b>Other Matters Associated with Audits</b>	
AS 6101	Letters for Underwriters and Certain Other Requesting Parties
AS 6105	Reports on the Application of Accounting Principles
AS 6110	Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance
AS 6115	Reporting on Whether a Previously Reported Material Weakness Continues to Exist

SOURCE: <https://pcaobus.org/Standards/Auditing/Pages/default.aspx>.

### Disclosure of Engagement Partner and Other Audit Participants

100.15 The PCAOB adopted a transparency rule in Release No. 2015-008, *Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*. The primary disclosure requirements of the final rule include disclosure of the name of the engagement partner, as well as information on the involvement of other accounting firms that took part in the audit. The transparency rules require firms to file the newly created PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*. Firms are required to file the form for each issuer audit. The term *issuer audits* used in the transparency rule specifically excludes audits of nonissuer broker-dealers. It does, however, include employee stock purchase plans and similar plans required to file a Form 11-K. The final rule introduced PCAOB Rule 3210, *Amendments*; Rule 3211, *Auditor Reporting of Certain Audit Participants*; and Form AP, *Auditor Reporting of Certain Audit Participants*. It also amended AS 3101, *Reports on Audited Financial Statements* (formerly AU 508), and AS 1205, *Part of the Audit Performed by Other Independent Auditors* (formerly AU 543). For more details on these disclosures, see the discussion beginning at paragraph 1004.3. The "Form AP Auditor Documentation Checklist" and "Form AP—Other Auditor Participation Worksheet" at PCA-CX-16.5 and PCA-CX-16.5.1, respectively, may be used to collect and retain the documentation required to prepare PCAOB Form AP.

### Recently Issued PCAOB Auditing Standards

100.16 **Accounting Estimates Including Fair Value Estimates.** In December 2018, the PCAOB adopted an auditing standard on estimates in Release 2018-005, *Auditing Accounting Estimates, Including Fair Value Measurements*. The standard, AS 2501 (Revised), applies when auditing estimates in significant accounts and disclosures, including valuations and allocations related to business combinations. The Release replaces three previous auditing standards: AS 2501, *Auditing Accounting Estimates*, supersede AS 2502, *Auditing Fair Value Estimates and Disclosures*, and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. It also rescinds AI 16, an auditing interpretation of AS 2501. The Release also

amends various other auditing standards. AS 2501 (Revised) is effective for audits of periods ending on or after December 15, 2020, and applies to all audits conducted under PCAOB standards. This edition of the *Guide* incorporates the requirements of the revised standard and amendments. See section 807 for further discussion of the revised standard and related amendments. PCAOB Release 2018-005 is available at <https://pcaobus.org/Rulemaking/Docket043/2018-005-estimates-final-rule.pdf>.

**100.17 Using the Work of Specialists.** In December 2018, concurrent with the issuance of AS 2501 (Revised), the PCAOB issued Release 2018-006, *Amendments for Auditor's Use of the Work of Specialists*, which, among other things, (a) revises AS 1105, *Audit Evidence*, by adding a new Appendix A to address using the work of a company's specialist as audit evidence, including procedures for evaluating the data, assumptions, and methods used by a company specialist, (b) replaces AS 1210, *Using the Work of a Specialist*, and renames it *Using the Work of an Auditor-Engaged Specialist*, and (c) amends AS 1201, *Supervision of the Audit Engagement*. The revisions and amendments are effective for audits of periods ending on or after December 15, 2020. This edition of the *Guide* incorporates the requirements of the revised standard and amendments. See section 807 for further discussion of the amendments. PCAOB Release 2018-006 is available at <https://pcaobus.org/Rulemaking/Docket044/2018-006-specialists-final-rule.pdf>.

**100.18 Auditor's Report.** In June 2017, the PCAOB adopted AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, which supersedes portions of AS 3101, *Reports on Audited Financial Statements*, and surviving guidance from AS 3101 becomes AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*. Key aspects of the standard include requirements to—

- Include a section in the auditor's report describing *critical audit matters* (CAMs), which are defined as any matter communicated to the audit committee relating to material accounts or disclosures that involve particularly challenging, subjective, or complex auditor judgment, and may include matters such as significant management estimates, areas of high audit risk, significant unusual transactions, and significant changes in the financial statements. The auditor's report is required to describe the primary reasons the auditor designated the matter as a CAM, how each matter was addressed in the audit, and make reference to the relevant financial statement accounts or disclosures. While the PCAOB expects most audit reports to include CAMs, if the auditor determines that no matters meet the CAM criteria, the auditor's report should state that fact. (Certain audits are exempt from the CAM requirement, including those of emerging growth companies, broker-dealers reporting under SEC Rule 17a-5, investment companies, employee stock purchase plans, savings plans, and similar benefit plans.)
- Include a statement in the auditor's report (1) that the auditor is a public accounting firm registered with the PCAOB and is required to be independent in accordance with U.S. federal securities laws and applicable rules of the SEC and PCAOB and (2) regarding the auditor's tenure with the company, including the year that the auditor began serving consecutively as the company's auditor.
- Address the auditor's report to the company's shareholders and board of directors (or as appropriate for companies not organized as corporations).
- Present the opinion section of the auditor's report first. (The order of other report sections is not specified.) In addition, the auditor's report should use titles to identify each section of the auditor's report.
- Include reference to "the related notes" when describing the financial statements that are audited, and add the phrase "whether due to error or fraud" to the description of the auditor's responsibility to obtain reasonable assurance about whether the financial statements are free from material misstatement.



The standard also amends various other PCAOB standards, including AS 1301, *Communications with Audit Committees*, which would require auditors to provide a draft of the auditor's report to the audit committee and to discuss it with them.

100.19 The standard has been approved by the Securities and Exchange Commission and is effective for audits of fiscal years ending on or after December 15, 2017, except for the provisions relating to the disclosure of critical audit matters, which are phased in and apply for fiscal years ending on or after June 30, 2019, for "large accelerated filers" and fiscal years ending on or after December 15, 2020, for other issuers to which the standard applies. The final standard can be accessed at <https://pcaobus.org/Rulemaking/Docket034/2017-001-auditors-report-final-rule.pdf>. See section 905 for a detailed discussion of the standard and Appendixes 9A-1–9A-9 for illustrative reports.

### Proposed PCAOB Auditing Standards

100.20 **Supervision of Other Auditors.** In April 2016, the PCAOB published Release No. 2016-002, *Proposed Amendments to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard—Dividing Responsibility for the Audit with Another Accounting Firm*, which addresses the planning, supervision, and performance of audits that involve other auditors and multi-location audit engagements. The release proposes amendments to existing PCAOB auditing standards and rules, as well as a new standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*. The proposal was generated in response to differences in practice among firms observed by the PCAOB and continued deficiencies in this area identified in PCAOB inspections, such as those discussed beginning at paragraph 1005.52. In Release 2016-002, the PCAOB proposes strengthening the existing standards and establishing more uniform practices for lead auditors supervising other auditors. After analyzing the comments received on the proposal, in September 2017, the PCAOB issued a supplemental request for comment to clarify and refine certain provisions in the original proposal by (a) directing the lead auditor's responsibilities to the areas of greatest risk, (b) clarifying that the lead audit firm must audit a meaningful portion of the financial statements, and (c) requiring more explicit procedures to promote increased lead auditor involvement in the work of other auditors.

### SEC Rules and PCAOB Standards for Broker-dealers

100.21 On July 31, 2013, the SEC issued a final rule that, among other things, requires audits of all broker-dealers (including *nonpublic* broker-dealers) be conducted in accordance with PCAOB standards. The *Dodd-Frank Wall Street Reform and Consumer Protection Act* had previously given oversight authority to the PCAOB for audits of broker-dealers that are registered with the SEC. Thus, the PCAOB now has responsibility for standard-setting, inspections, investigations, and disciplinary proceedings for registered accounting firms' audits of broker-dealers, including broker-dealers that are nonissuers. (See paragraph 101.5.) The rules also require broker-dealers to file new reports with the SEC. A comprehensive discussion of audits of broker-dealers is beyond the scope of this *Guide*. *PPC's Practice Aids for Audits of Broker-Dealers* provides detailed information on performing such audits.

100.22 In October 2013, the PCAOB approved two attestation standards that provide requirements for examining or reviewing the assertions in the broker-dealer's compliance report or exemption report, respectively, as indicated in the SEC's amendments to Rule 17a-5 of the Securities Exchange Act of 1934. The following is a summary of the adopted standards:

- *Examination Engagements Regarding Compliance Reports of Broker-Dealers.* The attestation standard requires auditors to obtain evidence to express an opinion on the assertions of the broker-dealer in the compliance report. In addition, it provides requirements for a risk-based approach for the examination. The requirements are designed to be scalable for the size and complexity of the broker-dealer. In addition, the requirements coordinate the examination engagement with the audit of the financial statements and supplemental information. The standard includes requirements for the auditor's report, as well as an illustrative report.

- *Review Engagements Regarding Exemption Reports of Broker-Dealers.* The attestation standard provides requirements for making inquiries and performing other procedures directed to the auditor's responsibility to obtain moderate assurance that the broker-dealer meets the identified conditions for an exemption from Exchange Act Rule 15c3-3. The procedures allow the auditor to scale the engagement based on the size and complexity of the broker-dealer. As part of the procedures, the auditor evaluates relevant evidence obtained from the audit of the financial statements and supplemental information. The standard includes reporting requirements and an illustrative report.

### AICPA Statement on Quality Control Standard No. 8

100.23 In 2007, the AICPA issued Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control*. SQCS No. 7 superseded and replaced all of the AICPA quality control standards that existed at the time. SQCS No. 7 comprehensively addressed the quality control practices over a firm's accounting and auditing practice and placed an unconditional obligation on the firm to establish a QC system designed to provide reasonable assurance that the firm (a) complies with professional standards and legal and regulatory requirements and (b) issues reports that are appropriate in the circumstances. In October 2011, the AICPA issued Statement on Quality Control Standard No. 8, *A Firm's System of Quality Control*, which superseded SQCS No. 7 and applied to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2012.

100.24 Because SQCS No. 8 (QC 10) was issued by the AICPA after 2003, it is not included in the Interim Quality Control Standards adopted by the PCAOB. As a result, it does not address the quality control ramifications of PCAOB standards that must be followed by auditors of issuers, nor does it include any modifications that may be necessary for a firm's system of quality control to conform to PCAOB standards. However, in certain areas, SQCS No. 8 incorporates requirements that are more comprehensive than existing PCAOB Interim Quality Control Standards. The authors believe that following the requirements of SQCS No. 8 in those areas is prudent and can increase engagement effectiveness. Further, the authors believe that firms will not ordinarily establish less rigorous QC policies and procedures for audits of issuers than those required for audits of nonissuers. Thus, when requirements of SQCS No. 8 are more stringent than those of the PCAOB Interim Quality Control Standards, such requirements have been incorporated throughout this *Guide*.

100.25 In December 2019, the PCAOB issued a Concept Release, *Potential Approach to Revisions to PCAOB Quality Control Standards*, regarding potential changes to the PCAOB quality control standards. The Concept Release explains that the PCAOB is considering an approach using the IAASB-proposed quality control standard, International Standard on Quality Management 1 (ISQM 1), *Quality Management for Firms that Perform Audits or Reviews of Financial statements, or Other Assurance or Related Services Engagements*, as a starting point. The proposed ISQM 1 focuses on proactive identification and response to risks that could affect engagement quality, including specific requirements that are not addressed in current PCAOB quality control standards. The PCAOB recognizes that firms that follow PCAOB standards may also follow IAASB standards (as well as those of the AICPA), and that it would be impractical to require firms to comply with multiple quality control standards that are fundamentally different. As a result, the Concept Release suggests incremental or alternative requirements to ISQM1 that may need to be made for firms performing engagements under PCAOB standards. In addition, the future PCAOB quality control standard is intended to be scalable so firms can tailor their QC systems based on their size and the nature of their engagements.

100.26 The Concept Release is available at <https://pcaobus.org/Rulemaking/Docket046/2019-003-Quality-Control-Concept-Release.pdf>. Future editions of this *Guide* will provide updates on the PCAOB's Concept Release on quality control.

### Recent Developments

100.27 **Credit Losses.** In June 2016, the FASB issued ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, which affects all entities that hold

financial assets and net investment in leases that are not accounted for at fair value through net income. The ASU is intended to provide users of financial statements with additional decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit. For public business entities that are SEC filers, excluding entities eligible to be *smaller reporting companies*, the ASU is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. In November 2019, the FASB issued ASU 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*. The ASU defers the effective date for *smaller reporting companies* until fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. All entities may early adopt the ASU in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. FASB ASU 2016-13 has been incorporated in this edition of the *Guide*.

## 101 HOW TO USE THIS GUIDE

101.1 This *Guide* provides a step-by-step approach to providing audit services to issuers under PCAOB standards. It is designed to help firms comply with PCAOB standards as well as appropriate SEC measurement and disclosure requirements. The *Guide* is divided into two sections—text and practice aids. The text portion (Chapters 1–10) describes the authors’ suggested audit approach and should be read by all engagement team members who are performing a financial statement audit only or an integrated audit under the PCAOB standards. The practice aids should be tailored for the unique aspects of each engagement and can be used to document much of the auditor’s work.

### Performing Audits of Nonpublic Entities Using PCAOB Standards

101.2 As previously noted, this *Guide* was developed to help firms who audit issuers. However, the PCAOB standards can be used in audits of nonpublic entities as well. Firms that wish to use this *Guide* as a tool in auditing nonpublic entities should consider the guidance in the PCAOB Staff Question and Answer document entitled *Audits of Financial Statements of Non-Issuers Performed Pursuant to the Standards of the Public Company Accounting Oversight Board*. This document can be found at <http://pcaobus.org/Standards/QandA/06-30-2004.pdf>. In addition, firms need to consider SAS No. 131, *Amendment to Statement on Auditing Standards No. 122 Section 700, Forming an Opinion and Reporting on Financial Statements*, from the AICPA. Issued in January 2016 and effective for audits of periods ending on or after June 30, 2016, it provides requirements and guidance for reporting for audits that are conducted under GAAS and PCAOB standards. Among other things, the standard notes that when an audit is conducted in accordance with the standards of the PCAOB, but not within the jurisdiction of the PCAOB, the auditor is also required to comply with GAAS. In that situation, the auditor should use the report layout and wording as specified by the PCAOB and indicate the audit was also conducted in accordance with GAAS.<sup>1</sup>

101.3 On March 1, 2018, the AICPA issued Interpretation No. 4 of AU-C 700B, *Reporting on Audits Conducted in Accordance with Auditing Standards Generally Accepted in the United States of America and the Standards of the PCAOB* (AU-C 9700B.14–.21). The interpretation provides clarification on application of the PCAOB’s new reporting model, as discussed beginning at paragraph 1001.16. It explains that auditors may need to make certain modifications to the PCAOB reporting model based on circumstances of the engagement to avoid making any untrue statement(s). For example, if the firm is not registered with the PCAOB, it is appropriate to remove the term “registered” from language prescribed by the PCAOB in the Basis of Opinion section of the report. It also states that it would be appropriate to revise the statement in the report regarding independence under SEC and PCAOB standards if the firm is not required by law or regulation to comply with those standards for the engagement. It suggests replacing this statement with, “We are required to be independent with respect to the Company in accordance with the relevant ethical

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<sup>1</sup> This guidance is unchanged by SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, which is effective for audits of financial statements for periods ending on or after December 15, 2021, as deferred by SAS No. 141, with early implementation permitted. The revised AU-C 700.46 states that the auditor should use the report layout and wording as specified by the PCAOB and indicate the audit was also conducted in accordance with GAAS.

requirements relating to our audit,” to encompass relevant AICPA ethics requirements. In addition, the references to conducting the audit in compliance with “the standards of the PCAOB” may need to be revised to specify “the auditing standards of the PCAOB,” if the engagement does not require compliance with the other PCAOB professional practice standards, such as the independence rules. Finally, the interpretation includes two illustrative examples at AU-C 9700B.21.

101.4 Interpretation No. 4 does not currently address the communication of CAMs, which are required for fiscal years ending on or after June 30, 2019 for large accelerated filers and fiscal years ending on or after December 15, 2020 for other issuers to which the standard applies. However, in May 2019, the AICPA issued SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*. SAS No. 134 is effective for audits of financial statements for periods ending on or after December 15, 2021, as deferred by SAS No. 141, with early implementation permitted. Among other things, SAS No. 134 supersedes and replaces AU-C 700B, *Forming an Opinion and Reporting on Financial Statements*. AU-C 700.A64, as clarified by SAS No. 134, provides that audits conducted in compliance with the standards of the PCAOB ought to follow the relevant requirements in the PCAOB standards regarding the determination and reporting of critical audit matters.

101.5 Section 982 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Dodd-Frank Act), which was signed into law in July 2010, amended the Sarbanes-Oxley Act to (a) require auditors of all broker-dealers to register with the PCAOB and (b) authorize the PCAOB to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms regarding audit reports included in broker-dealer filings with the SEC. As further noted in the discussion beginning at paragraph 100.7, in 2013 the SEC issued a final rule that requires that all audits of broker-dealers (including *nonpublic* broker-dealers) be conducted in accordance with the standards of the PCAOB. Also, the PCAOB issued two attestation standards and AS 2701 that apply to examinations and reviews of broker-dealer reporting.<sup>2</sup> A comprehensive discussion of audits of broker-dealers is beyond the scope of this *Guide*. *PPC's Practice Aids for Audits of Broker-Dealers* provides detailed information on such audits.

## Library Resources

101.6 This *Guide* is an audit engagement guidance product that provides an auditor the tools necessary to perform recurring audits and interim reviews under PCAOB standards and related SEC measurement and disclosure requirements. However, the *Guide* is not intended to address audits of initial public offerings (IPOs) in connection with the Securities and Exchange Act of 1933 or to be a comprehensive source of information about SEC rules and regulations. Instead, it should be considered an important component of a professional library that includes additional resources. Some of the resources that the authors suggest are as follows:

- *Sarbanes-Oxley Act of 2002*, copies of which are usually available in comprehensive SEC services such as [www.sec.gov/about/laws.shtml](http://www.sec.gov/about/laws.shtml) and the ones cited below. In addition, the act can be found on the Internet in several locations.
- All PCAOB standards. PPC offers a comprehensive PCAOB standards package in an online format. In addition, these standards are included on Checkpoint, an online resource offered by Thomson Reuters. [PPC and Checkpoint resources can be ordered by calling (800) 431-9025 or at **tax.thomsonreuters.com**.]
- GAAP as contained in the *Accounting Standards Codification* and superseded standards issued by the Financial Accounting Standards Board (FASB) and the AICPA. Since financial statements of public companies must be prepared in accordance with generally accepted accounting principles, a library that includes the standards as well as other GAAP resources, such as *PPC's Guide to GAAP*

<sup>2</sup> PCAOB rules and forms to apply to audits and auditors of broker-dealers, requiring firms that audit broker-dealers to comply with PCAOB professional practice standards. PCAOB Release No. 2013-010, *Amendments to Conform the Board's Rules and Forms to the Dodd-Frank Act and Make Certain Updates and Clarifications* can be found at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket039.aspx>.



and *PPC's Guide to Preparing Financial Statements*, can be very useful. PPC offers comprehensive FASB and AICPA packages in CD-ROM and online formats. In addition, these standards are included on Checkpoint, an online resource offered by Thomson Reuters. [PPC and Checkpoint resources can be ordered by calling (800) 431-9025 or at [tax.thomsonreuters.com](http://tax.thomsonreuters.com).]

FASB *Accounting Standards Codification* also includes relevant portions of certain SEC rules, regulations, interpretive releases, and staff guidance pertaining to financial accounting and reporting that are relevant only to issuers. Examples of such SEC guidance are Regulation S-X, Financial Reporting Releases (FRR), Accounting Series Releases (ASR), Interpretative Releases (IR), SEC staff guidance in Staff Accounting Bulletins (SAB), EITF Topic D, and SEC Staff Observer comments. Such guidance is segregated within the *Codification* and identified with the same two digit section numbers and titles as the FASB sections, except that the SEC material is preceded by the letter "S." In addition, certain topics also include a separate section—S99, *SEC Materials*, consisting of SEC content. (The SEC content is included in the FASB's *Accounting Standards Codification* as a convenience to users and does not represent the authoritative sources of such content.)

- Audit and reporting standards of the Securities and Exchange Commission. Checkpoint offers several SEC services that could be helpful, including *SEC Expert: Domestic Filers*, which provides guidance for all the major domestic SEC registration and periodic reporting forms with linking to primary source materials, and *SEC Compliance: Financial Reporting and Forms*, which is a more comprehensive service that includes the official text of rules and regulations, agency documents and forms, and explanations of all necessary filings. [To order Checkpoint, call the Thomson Reuters order department at (800) 431-9025 or visit [tax.thomsonreuters.com](http://tax.thomsonreuters.com).]
- The Center for Audit Quality (CAQ), an autonomous public policy organization affiliated with the AICPA, makes available various resources to auditors of public companies, including Alerts that provide information about developments in accounting, auditing, and regulatory matters, periodic Webcasts on current issues, comment letters on PCAOB and SEC rulemaking proposals, white papers, technical practice aids, and best-practice documents. (Certain information is available only to members of the CAQ.) The Center for Audit Quality can be accessed at [www.thecaq.org](http://www.thecaq.org).
- There are numerous resources available online that can be very helpful to auditors of public companies. One such resource, the *WG&L Accounting & Compliance Alert*, is an electronic newsletter that keeps subscribers informed of the latest SEC, PCAOB, GAAP, and FASB developments regarding accounting, reporting, and disclosure requirements. [To order Checkpoint, call the Thomson Reuters order department at (800) 431-9025 or visit [tax.thomsonreuters.com](http://tax.thomsonreuters.com).]
- Auditors should check the PCAOB's website periodically for new content. Not only are new and proposed standards included on that site, but there are also other useful resources, such as inspection reports and Staff Questions and Answers. The PCAOB's website can be accessed at <http://pcaobus.org>.

101.7 Almost all publishers that provide accounting and auditing information do so electronically, offering an array of resources and information for auditors of public companies. In addition to a complete library of GAAP, PCAOB, and SEC rules, regulations, and standards, Thomson Reuters, publisher of PPC and WG&L brand products, provides online access to most of its product line on Checkpoint. To see a list of products offered, visit [tax.thomsonreuters.com](http://tax.thomsonreuters.com).

## 102 ORGANIZATION OF THIS GUIDE

102.1 As previously noted, this *Guide* provides a step-by-step approach to providing audit and review services for issuers. The following paragraphs discuss the organization of the *Guide* in more detail.

## **Chapter 2—“Preliminary Engagement Activities”**

102.2 Chapter 2 explains the activities that take place (a) before an engagement is accepted and (b) in the early planning stages of an engagement. Chapter 2 includes discussions of client acceptance and continuance, establishing the terms of the engagement, and special planning considerations relating to an initial engagement.

## **Chapter 3—“Risk Assessment Procedures and Planning”**

102.3 Chapter 3's focus is on general planning decisions. General or preliminary planning should be distinguished from detailed planning of audit procedures, which is the subject of Chapter 6. Preliminary planning includes deciding on an overall strategy for the audit; obtaining an understanding of the entity and its environment, including internal control (for a financial statement audit only); making an initial assessment of audit risk and materiality, considering fraud; and deciding on the overall timing of the engagement. (Auditing internal control is addressed in Chapter 5.)

## **Chapter 4—“Management’s Responsibility for Internal Control”**

102.4 Chapter 4 is the first of two chapters related to the procedures that should be performed in auditing a client's internal control over financial reporting. Among other topics, this chapter discusses the framework (such as COSO) used by management to evaluate its internal controls. The chapter discusses COSO's Framework and internal control frameworks commonly used in Canada and the United Kingdom. In addition, this chapter discusses management's responsibilities for assessing and reporting on internal control over financial reporting. Chapter 4 also includes a section on special considerations for smaller public companies that may not have the strong segregation of duties that larger companies have.

## **Chapter 5—“Auditing Internal Control over Financial Reporting”**

102.5 Chapter 5 provides an overview of the process that should be followed when performing an audit of a company's internal control over financial reporting. The guidance in this chapter along with the related practice aids are designed to walk an auditor through all stages of the internal control audit process, from the initial planning phase through all phases of the audit. Chapter 5 also discusses the requirements related to AS 1220 on performing voluntary engagements to determine whether previously reported material weaknesses in internal control over financial reporting continue to exist as of a date specified by management.

## **Chapter 6—“Assessing Risks and Developing the Detailed Audit Plan”**

102.6 Chapter 6 focuses on (a) assessing the risks identified by the auditor throughout the process of performing the risk assessment procedures and (b) selecting responses that are appropriate to address those risks. Chapter 6 includes discussions of financial statement assertions, identifying and assessing risks at the assertion level, considering fraud risks, and responding to the risk assessment and preparing the detailed audit plan.

## **Chapter 7—“Substantive Procedures and Documentation”**

102.7 Chapter 7 discusses substantive procedures, which consist of tests of details and substantive analytical procedures. Included in the chapter is a discussion of substantive procedures required in every audit, choosing substantive procedures, performing tests of details, performing substantive analytical procedures, responding to fraud risks, considerations when performing interim audit procedures, and audit documentation and retention.

## **Chapter 8—“General Procedures and Summary Documentation”**

102.8 Chapter 8 discusses several important procedures that are more general in nature and not necessarily affected by the auditor's risk assessments. Topics include the following:



- Procedures to search for commitments and contingencies, including obtaining legal representations.
- Procedures to search for subsequent events that occur after the balance sheet date that affect either the company's financial statements or its internal control over financial reporting.
- Procedures to identify related parties and evaluate the disclosure of related-party transactions.
- Evaluating whether there is a substantial doubt about the entity's ability to continue as a going concern.
- Procedures to identify and evaluate the disclosure requirements and auditing considerations related to risks and uncertainties.
- Obtaining written representations from management in a management representation letter.
- Procedures for performing an engagement quality review as required by AS 1220.

In addition, the chapter discusses engagement wrap-up procedures, such as summarizing and evaluating the overall results of audit tests, analytical review and review of workpapers, developing an overall engagement summary memorandum, and audit committee communications.

### **Chapter 9—"Reporting and Other Auditing Considerations"**

102.9 Chapter 9 discusses several important topics, including reporting on a company's financial statements and special considerations that should be considered in initial audits. It also covers the reporting requirements of AS 2201 as well as the reporting considerations related to performing a voluntary engagement under AS 6115 to determine whether previously reported material weaknesses in internal control over financial reporting continue to exist. Chapter 9 discusses auditing supplemental information, the use of specialists, internal auditors, and other auditors' work in an engagement. Unique issues involved in audits of consolidated or combined financial statements and the use of data extraction techniques are also discussed in Chapter 9.

### **Chapter 10—"Other SEC and PCAOB Matters"**

102.10 Chapter 10 discusses matters unique to public companies, including performing interim reviews of financial information, SEC accounting and disclosure issues, special PCAOB audit issues, PCAOB inspections, the auditor's responsibility for other information accompanying audited financial statements in SEC filings in accordance with Reg. S-K for larger companies and smaller reporting companies, and firm registration and reporting with the PCAOB.