
STAFF AUDIT PRACTICE ALERT NO. 6

**AUDITOR CONSIDERATIONS REGARDING USING THE WORK OF OTHER
AUDITORS AND ENGAGING ASSISTANTS FROM OUTSIDE THE FIRM**

July 12, 2010

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Introduction

The PCAOB staff has observed that a number of registered public accounting firms located in the United States ("U.S.") have been issuing audit reports on financial statements filed by issuers that have substantially all of their operations outside of the U.S. Although there is nothing inherently inappropriate about this, observations from the Board's inspection process suggest that some firms may not be conducting those audits in accordance with PCAOB standards. Specifically, some firms may be issuing audit reports based on the work of another firm, or by using the work of assistants engaged from outside of the firm, without complying with relevant PCAOB standards.

The circumstances in which such conduct occurs often involve issuers that are incorporated in the U.S. (and that file their annual reports with the Securities and Exchange Commission ("SEC") on Form 10-K), even though substantially all of their operations are in another country. In this context, a number of issuers have come to be incorporated in the U.S., and to have securities trading in the U.S., following a transaction in which an operating company in another country merges with a U.S. shell company that had previously registered its securities under the Securities Exchange Act of 1934.

The number of issuers that file financial statements audited by U.S. auditors, while having substantially all of their operations in another country, has increased in recent years. The demand for those audit services is met by U.S. registered public

accounting firms of various sizes, including small firms.^{1/} The Board's inspection staff has observed some situations in which it appeared that U.S. registered public accounting firms that provided those auditing services did so by having all or most of the audit performed by another firm or by assistants engaged from outside the firm (including firms and assistants located in another country) without complying with PCAOB standards applicable to using the work and reports of another auditor and supervising assistants.^{2/} Prompted by those observations, this Alert is intended as a reminder to registered firms concerning a firm's obligations when using the work of other firms or using assistants engaged from outside the firm.

Using the Work of Other Auditors

AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, establishes requirements that apply when an auditor of an issuer's financial statements "use[s] the work and reports of other independent auditors who have audited the financial

^{1/} For example, in a 27-month period ending March 31, 2010, at least 40 U.S. registered public accounting firms with fewer than five partners and fewer than ten professional staff issued audit reports on financial statements filed with the SEC by companies whose operations were substantially all in the China region. (As used in this Staff Audit Practice Alert, the term "China region" includes the People's Republic of China, Hong Kong Special Administrative Region, and Taiwan.) This trend has also attracted attention, and was a subject of discussion at a recent meeting of the Board's Standing Advisory Group (available beginning at minute 43:15 of the archived Webcast at <http://pcaobus.org/News/Webcasts/Documents/2010/pcaob-040710-p2.mp3>). This trend is not necessarily limited to the China region, and the discussion in this Staff Audit Practice Alert of issues associated with the U.S. registered public accounting firms' audits of companies whose operations were substantially all in the China region also is relevant to audits of companies located in other jurisdictions.

^{2/} Where appropriate, the Board follows up on indications of such misconduct with enforcement investigations, disciplinary proceedings, and sanctions. By law, these Board processes are nonpublic unless and until they result in a final disciplinary sanction taking effect. In one completed matter, the Board imposed sanctions in a case in which a U.S. firm used a significant amount of audit work performed by a Hong Kong firm without adequately coordinating its work with that of the Hong Kong firm. See *In the Matter of Clancy and Co., P.L.L.C., Jennifer C. Nipp, CPA, and Judith J. Clancy, CPA*, PCAOB Release No. 105-2009-001 (March 31, 2009). Referrals from the Board's inspection program to the Board's enforcement program relating to situations in which firms are using work of other firms or using assistants from outside the firm in connection with audits of foreign-based issuers have been on the rise.

statements of one or more subsidiaries, divisions, branches, components, or investments included in [that issuer's] financial statements."^{3/}

The Board's inspection staff has identified indications that some U.S. firms auditing issuers with substantially all of their operations in another country are not properly applying AU sec. 543. For example, in one situation, a U.S. firm engaged to audit such an issuer retained an accounting firm in the China region to perform audit procedures. In the year preceding the audit, the U.S. firm's managing partner and engagement partner traveled to the China region to meet with the issuer's board of directors, the issuer's management, and the other firm in order to gain an understanding of the issuer's business and processes and review with the other firm its audit process. The U.S. firm's personnel did not travel to the China region during the audit, and the audit procedures performed by the other firm constituted substantially all of the audit procedures on the issuer's financial statements. The firm in the China region did not issue a report, and substantially all of the audit documentation was maintained by the firm in the China region. Based on its view that AU sec. 543 applied and permitted it to do so, the U.S. firm issued an audit report stating that it had audited the financial statements and expressing an unqualified opinion on the financial statements. The inspection staff, however, concluded that it was inappropriate for the firm to serve as principal auditor and use the work of the other auditor pursuant to AU sec. 543.

Identifying Circumstances in Which AU sec. 543 Applies

AU sec. 543 applies only to circumstances in which a firm would use the "work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments" of an issuer.^{4/} AU sec. 543 does not provide a way for an auditor to take responsibility for the work of another auditor that has essentially audited an issuer's financial statements in their entirety, even if the firm complies with the other requirements in AU sec. 543. AU sec. 543 does not apply to the use of another auditor's work if that work is anything other than an audit of the financial statements of one or more subsidiaries, divisions, branches, components, or investments of the issuer.

Determining Whether to Serve as Principal Auditor

Even in circumstances where a firm has access to the work and reports of another auditor that has audited the financial statements of a subsidiary, division, branch, component, or investment, the firm cannot serve as principal auditor (and, accordingly, may not sign the audit report on the issuer's financial statements) unless

^{3/} AU sec. 543.01.

^{4/} Ibid.

the firm's own participation in the audit is sufficient.^{5/} In determining whether its participation is sufficient to serve as principal auditor, the firm "should consider, among other things, the materiality of the portion of the financial statements [the firm] audited in comparison with the portion audited by other auditors, the extent of [the auditor's] knowledge of the overall financial statements, and the importance of the components [the firm] audited in relation to the enterprise as a whole."^{6/} If an issuer has no significant operations other than those in another country, a registered public accounting firm that plays no significant part in the audit of the foreign operations is highly unlikely to have sufficient participation in the audit to serve as the issuer's principal auditor. A lack of sufficient participation cannot be overcome by using the work of the other auditor, even if the firm assumes responsibility for that work.

Responsibilities of the Principal Auditor

In circumstances in which AU sec. 543 applies and in which the firm's own participation is sufficient to serve as principal auditor, the principal auditor must comply with the other requirements in AU sec. 543 relative to the firm's use of the work and reports of the other auditor,^{7/} including:

- *Determining the Method of Reporting* – The principal auditor must decide, taking certain factors into account, whether to express an opinion on the financial statements taken as a whole without making reference to the audit of the other auditor (thereby assuming responsibility for the work of the other auditor) or to make reference to the audit of the other auditor.^{8/}
- *Procedures Applicable to Both Methods of Reporting* – The principal auditor "should make inquiries concerning the professional reputation and independence of the other auditor [and] adopt appropriate measures to assure the coordination of [the principal auditor's] activities with those of

^{5/} See AU sec. 543.02.

^{6/} AU sec. 543.02. In an integrated audit, the auditor who serves as the principal auditor of the financial statements should also be the principal auditor of internal control over financial reporting ("ICFR") and so must participate sufficiently in the audit of ICFR to provide a basis for serving as the principal auditor of ICFR. See Paragraph C8 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

^{7/} AU sec. 543.03-.17.

^{8/} See AU sec. 543.03-.06.

the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements."^{9/}

- *Procedures Applicable When Assuming Responsibility* – If the principal auditor assumes responsibility for the work of the other auditor, the principal auditor "must obtain, and review and retain ... prior to the report release date", certain specific information from the other auditor, and should also consider "[visiting] the other auditor and [discussing] the audit procedures followed and results thereof; [reviewing] the audit programs of the other auditor [and, if appropriate, issuing] instructions to the other auditor as to the scope of the audit work; [and/or reviewing] additional audit documentation of the other auditor relating to significant findings or issues in the engagement completion document."^{10/}

If the principal auditor assumes responsibility for the work of other auditors, the principal auditor should determine whether the results of the principal auditor's own work, combined with the results of the work of other auditors, provide sufficient competent evidential matter to afford a reasonable basis for an audit opinion on the issuer's financial statements.^{11/} In developing an opinion, the principal auditor "should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements."^{12/}

The principal auditor must exercise due professional care in the performance of the audit.^{13/} When the principal auditor assumes responsibility for the other auditor's

^{9/} AU sec. 543.10. In connection with this point, both the principal auditor and auditors whose work and reports the principal auditor uses should be cognizant of PCAOB registration requirements. Under section 102(a) of the Sarbanes-Oxley Act of 2002 and PCAOB Rule 2100, *Registration Requirements for Public Accounting Firms*, an auditor whose work and report the principal auditor uses must be registered with the PCAOB if that auditor's work constitutes "a substantial role in the preparation or furnishing of" the audit report on the issuer's financial statements, as defined in PCAOB Rule 1001(p)(ii), *Definitions of Terms Employed in Rules / Play a Substantial Role in the Preparation or Furnishing of an Audit Report*.

^{10/} AU sec. 543.12.

^{11/} See paragraph .02 of AU sec. 150, *Generally Accepted Auditing Standards*, and paragraph .08 of AU sec. 230, *Due Professional Care in the Performance of Work*.

^{12/} Paragraph .25 of AU sec. 326, *Evidential Matter*.

^{13/} See AU sec. 230.01.

work, the principal auditor's review of the audit documentation obtained from the other auditor^{14/} and performance of other required procedures may identify issues requiring additional consideration by the principal auditor, such as the following issues observed in some audits by the Board's inspection staff:

- The other auditor did not comply with instructions issued by the principal auditor.
- The other auditor identified an accounting or auditing issue that the other auditor did not resolve.
- The other auditor performed an audit in accordance with auditing standards other than the standards of the PCAOB.
- The other auditor reported on the financial statements of a component that prepares its financial statements in accordance with a financial reporting framework^{15/} other than the framework used to prepare the financial statements of the issuer as a whole.

To the extent the principal auditor has substantial doubt about any financial statement assertion of material significance, the principal auditor "must refrain from forming an opinion until [the principal auditor] has obtained sufficient competent evidential matter to remove such substantial doubt, or ... must express a qualified opinion or a disclaimer of opinion."^{16/} For example, if the principal auditor determines that the work of the other auditor does not provide the necessary audit evidence, the principal auditor should take appropriate actions to obtain sufficient competent evidence, including "[participating] in discussions regarding the accounts with management personnel of the component whose financial statements are being audited by other auditors and/or [making] supplemental tests of such accounts."^{17/}

^{14/} AU sec. 543.12 describes certain specific information that the principal auditor must obtain from the other auditor.

^{15/} U.S. generally accepted accounting principles and International Financial Reporting Standards are examples of a financial reporting framework. Auditors should look to the requirements of the SEC for the issuer under audit with respect to the accounting framework applicable to the issuer.

^{16/} AU sec. 326.25.

^{17/} AU sec. 543.13.

Language Considerations

Appropriately satisfying the requirements described above necessarily entails overcoming any language barriers. If the appropriate supervisory personnel of the principal auditor are not sufficiently fluent in the language in which the audit documentation of the other auditor is prepared, the principal auditor must take the necessary actions to enable the principal auditor to fulfill its responsibilities in accordance with PCAOB standards. The principal auditor can neither omit the procedures described in AU sec. 543 because of language differences, nor satisfy those requirements by reference to documents that the principal auditor does not understand.

Engaging Assistants from Outside the Firm

The previous section describes certain requirements in PCAOB standards that apply when a principal auditor uses the work and reports of other auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented. In other situations, the auditor might engage assistants from outside the firm in performing the audit. The auditor's responsibilities related to the work of assistants engaged from outside the firm are governed by the same standards as the auditor's responsibilities related to the work of assistants who are associated with the auditor's firm as a partner, shareholder, or employee.

The Board's inspection staff has identified situations in which U.S. firms auditing companies with substantially all of their operations in another country appeared not to have appropriately executed their responsibilities with respect to the work of assistants engaged from outside of the firm. For example, in one situation, a U.S. firm retained the services of a consulting firm that had personnel who could read, write, and speak the language of the area, in the China region, in which the issuer's operations were located. Those consultants planned the audit, communicated with the issuer's management, and traveled to the China region to complete a substantial portion of the audit. None of the U.S. firm's partners or employees traveled to the China region or planned, performed, supervised, or meaningfully reviewed the audit work. Procedures performed by the U.S. firm's engagement partner consisted primarily of reviewing certain work papers prepared by the consultants as well as issuer-prepared draft financial statements and lead schedules that had been translated into English. The inspection staff concluded that the level of the firm's involvement in the audit work performed by the consultants was not sufficient for the firm to assert that an audit had been performed by the firm and that the audit provided a reasonable basis for the firm to have an opinion on the financial statements.

As described further in this Alert, some key considerations in determining the appropriate level of the firm's involvement in audit work performed by assistants engaged from outside the firm (including planning, performing, and supervising the audit work) include, but are not limited to, the following:

- Whether the auditor would be able to obtain information about the knowledge, skill, and ability of the assistants engaged from outside the firm (including their knowledge of PCAOB standards and the relevant financial reporting requirements), and to evaluate the independence of the assistants engaged from outside the firm.
- Whether the auditor would be able to properly plan and supervise the work of the assistants engaged from outside the firm and whether the auditing procedures performed by such assistants, in combination with the work performed by individuals from within the firm, would provide sufficient competent evidential matter to afford a reasonable basis for an audit opinion.
- Whether the assistants engaged from outside the firm are located in the same country or speak the same language as the auditor or the auditor's client.
- Whether the auditor would be able to comply with the documentation requirements, including the preparation, assembly, and retention of documentation, with respect to the work performed by the assistants engaged from outside the firm.

Knowledge, Skill, Ability, and Independence

As is the case when a registered public accounting firm deploys its own partners, shareholders, or employees on an audit, when a registered public accounting firm engages assistants from outside of the firm, the firm's engagement partner "is responsible for the assignment of tasks to, and supervision of, [those] assistants."^{18/} Those assistants, like all assistants, should be "assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability",^{19/} which necessarily

^{18/} AU sec. 230.06.

^{19/} Ibid. A registered public accounting firm has a responsibility to ensure that all individuals who perform audit procedures for which the firm is responsible, including assistants engaged from outside the firm, comply with the professional standards applicable to the firm's auditing practice (see QC sec. 20.03) and that work is assigned to individuals who have the degree of technical training and proficiency required in the circumstances (see QC sec. 20.13).

requires the person who assigns and supervises the assistants to have an understanding of the level of knowledge, skill, and ability possessed by those assistants. The knowledge, skill, and ability of personnel assigned significant engagement responsibilities also should be commensurate with the auditor's assessment of the level of risk for the engagement, including the risk of material misstatement due to fraud.^{20/} Ordinarily, higher risk requires the assignment of more experienced personnel or additional persons with specialized skills and knowledge, e.g., information technology or forensic specialists.^{21/}

As for independence, the registered public accounting firm must approach independence considerations concerning the assistants engaged from outside the firm as if they were employees of the firm.^{22/}

Planning and Supervision

The registered public accounting firm is responsible for planning the audit, and for ensuring that the work of assistants is supervised and reviewed in accordance with PCAOB standards.

As the "auditor with final responsibility for the audit", as that term is used in paragraph .02 of AU sec. 311, *Planning and Supervision*, the registered public accounting firm's engagement partner is responsible for audit planning, which involves developing an overall strategy for the expected conduct and scope of the audit.^{23/} Procedures that an auditor may consider in planning the audit usually involve review of records relating to the company and discussions with assistants, including assistants engaged from outside the firm, and management of the company, the board of directors, or its audit committee.^{24/} "In planning the audit, the auditor should consider

^{20/} See paragraph .17 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, and paragraph .50 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

^{21/} Ibid.

^{22/} PCAOB standards require that policies and procedures be established to provide the firm with reasonable assurance that individuals who perform the audit maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities. (See QC sec. 20.09.)

^{23/} See AU sec. 311.03, and paragraph 9 of Auditing Standard No. 5.

^{24/} See AU sec. 311.04 (including examples of such procedures).

the nature, extent, and timing of work to be performed and should prepare a written audit program (or set of written audit programs)."^{25/}

"The auditor should obtain a level of knowledge of the [issuer's] business that will enable [the auditor] to plan and perform [the] audit in accordance with [PCAOB standards]."^{26/} "Knowledge of an [issuer's] business is ordinarily obtained through experience with the [issuer] or its industry and inquiry of personnel of the [issuer]."^{27/} Prior to, or in conjunction with, gathering information about the issuer's business, the engagement partner and key members of the audit team, including any engaged from outside the firm, should discuss the potential for material misstatement due to fraud.^{28/} The discussion should include, among other things, "an exchange of ideas or "brainstorming" ... about how and where [the auditor] believe[s] the [issuer's] financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the [issuer] could be misappropriated."^{29/}

Appropriate supervision and review necessarily entails overcoming any language barriers. The engagement partner is responsible for the supervision of assistants, including any engaged from outside the firm.^{30/} "Elements of supervision include instructing assistants, keeping informed of significant problems encountered, reviewing the work performed, and dealing with differences of opinion ... The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work."^{31/} "Ordinarily, higher risk requires ... more extensive supervision by the [engagement partner] during both the planning and the conduct of the engagement."^{32/} Also, "the extent of supervision should reflect the risks of material misstatement due to fraud."^{33/} "The work performed by each assistant should be reviewed to determine whether it was

^{25/} AU sec. 311.05.

^{26/} AU sec. 311.06.

^{27/} AU sec. 311.08.

^{28/} See AU sec. 316.14 and AU sec. 316.17.

^{29/} AU sec. 316.14.

^{30/} See AU sec. 230.06.

^{31/} AU sec. 311.11.

^{32/} AU sec. 312.17.

^{33/} AU sec. 316.50.

adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report."^{34/}

Audit Documentation

The registered public accounting firm is responsible for ensuring that all audit documentation – including the documentation of the work of the assistants – necessary to meet the PCAOB's documentation requirements is prepared and retained.^{35/} Auditing Standard No. 3, *Audit Documentation*, "establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the PCAOB."^{36/} Among other things, Auditing Standard No. 3 requires that the auditor "identify all significant findings or issues in an engagement completion document."^{37/} These requirements are applicable in situations in which the auditor engages, as assistants, individuals from outside the firm.

Engagement Quality Review

"[T]he engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the [audit] report"^{38/} including "[reviewing] the engagement completion document and [confirming] with the engagement partner that there are no significant unresolved matters."^{39/} "[T]he firm may grant permission to the client to use the [audit] report only after the engagement quality reviewer provides concurring approval of issuance."^{40/}

^{34/} AU sec. 311.13.

^{35/} See paragraph 18 of Auditing Standard No. 3, *Audit Documentation*.

^{36/} Paragraph 1 of Auditing Standard No. 3.

^{37/} Paragraph 13 of Auditing Standard No. 3.

^{38/} Paragraph 9 of Auditing Standard No. 7, *Engagement Quality Review*.

^{39/} Paragraph 10.e of Auditing Standard No. 7, *Engagement Quality Review*.

^{40/} Paragraph 13 of Auditing Standard No. 7.

Standard-setting Activities

The Board has a project on its standard-setting agenda regarding the responsibilities of the principal auditor. The Board's Standing Advisory Group discussed this topic at its April 7-8, 2010 meeting.^{41/}

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^{41/} See briefing paper available at http://pcaobus.org/News/Events/Documents/04072010_SAGMeeting/Principal_Auditor_Briefing_Paper.pdf.