

# Client Alert

May 2016

## PCAOB Adopts New Audit Firm Disclosure Rules

On May 10, 2016, the Securities and Exchange Commission approved new rules, and related amendments, previously adopted by the Public Company Accounting Oversight Board (the “PCAOB”) that are intended to provide investors and financial statement users with more information about who is participating in public company audits. The auditing standards require audit firms to disclose the names of each audit engagement partner, as well as the names of other audit firms that participated in each audit, in a new Form AP to be filed with the PCAOB.<sup>1</sup> The new rules require audit firms to begin making the required disclosures in 2017.

### Requirements of New Rules

Under the final rules, auditors will be required to file a new PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*, for each issuer audit, disclosing:

- The name of the engagement partner for the most recent audit;
- The names, locations and extent of participation of other accounting firms that took part in the audit, if their work constituted 5 percent or more of the total audit hours; and
- The number of all other accounting firms that took part in the audit whose individual participation was less than 5 percent of the engagement’s total audit hours, and the extent of those firms’ participation.
- Firms may voluntarily include such disclosures in the auditor’s report accompanying the issuer’s financial statements (i.e., the engagement partner, the other audit firms or both).

For purposes of Form AP, “other accounting firm” means (i) a registered public accounting firm other than the firm filing Form AP or (ii) any other person or entity that opines on the compliance of any entity’s financial statements with an applicable financial reporting framework.

### Form AP

The information on Form AP will be available in a searchable database on the PCAOB’s website and will include unique ID numbers for both engagement partners and firms to facilitate identification over time.

Form AP has a filing deadline of 35 days after the date the auditor’s report is first included in a document filed with the SEC, with a shorter deadline of 10 days after the auditor’s report is first included in a document filed with the SEC for IPOs.

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<sup>1</sup> The PCAOB is adopting two new rules (Rules 3210 and 3211) and one new form (Form AP). The PCAOB is also adopting amendments to AS 3101 (currently AU sec. 508), *Reports on Audited Financial Statements*, and AS 1205 (currently AU sec. 543), *Part of the Audit Performed by Other Independent Auditors*, related to voluntary disclosure in the auditor’s report.

Firms will file Form AP through the PCAOB's existing web-based Registration, Annual and Special Reporting system.

### **Rulemaking History**

The new rules have been under development for seven years. In 2008, the US Department of the Treasury's Advisory Committee on the Auditing Profession issued its final report recommending, among other things, that the PCAOB "undertake a standard-setting initiative to consider mandating the engagement partner's signature on the audit report."<sup>2</sup> The PCAOB began an analysis of this issue in 2009 when it issued a concept release on a requirement that the engagement partner sign his or her name to the auditor's report.<sup>3</sup> During the rulemaking process, the PCAOB considered several disclosure alternatives, including requiring the engagement partner's signature on the auditor's report, disclosure of the name of the engagement partner in the auditor's report, and providing a new form outside of the auditor's report on which to disclose the name of the engagement partner. The PCAOB's decision to require disclosure outside of the auditor's report on a new form, Form AP, reflects a compromise intended to balance the benefits of disclosure with concerns regarding the potential expansion of liabilities under the federal securities laws, including Section 11 of the Securities Act of 1933 and the antifraud provisions set forth under Section 10(b) and Rule 10b-5 under the Exchange Act. The compromise nature of the rule was acknowledged by PCAOB Board member Steve Harris, who strongly supports including the engagement partner's signature in the auditor's report: "I understand that reasonable people may agree to disagree, which is why I support today's compromise which will result in the creation of a new standardized form – the Form AP...."<sup>4</sup>

### **Disclosure of Other Auditors That Participated in the Audit and Proposed Rule on Lead Auditor Supervision**

While the focus of the debate leading to the adoption of this rule has largely centered on the signature or naming of the engagement partner in the audit report, the requirement that other auditors that participated in the audit be disclosed in Form AP is noteworthy, especially with respect to multinational audits. Chairman Doty, in his prepared statement at the open board meeting adopting the new rules,<sup>5</sup> noted that PCAOB inspections over time have revealed that the quality of audit engagements vary and that, currently, there is no way for an investor to determine how much of an audit was performed by firms other than the signing firm.

The new requirement should be viewed in tandem with the PCAOB's recently proposed rules requiring greater supervision by the lead auditor of the other auditors that participate in an audit.<sup>6</sup> Viewed together,

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<sup>2</sup> US Department of the Treasury's Advisory Committee on the Auditing Profession, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* (October 6, 2008).

<sup>3</sup> According to research conducted by PCAOB staff, 16 out of the 20 countries with the largest market capitalization already require disclosure of the name of the engagement partner: Japan, United Kingdom, France, Germany, Australia, India, Brazil, China, Switzerland, Spain, Russian Federation, the Netherlands, South Africa, Sweden, Mexico and Italy. The four countries that currently do not require the disclosure of the name of the engagement partner are the United States, Canada, Republic of Korea and Hong Kong. The International Auditing and Assurance Standards Board (IAASB) requires the auditor to include the name of the engagement partner in the auditor's report for audits of listed entities. Under EU law, the engagement partner is required to sign the audit report. Unlike disclosure of the engagement partner's name, disclosure of other accounting firms that participated in the audit is not required by the IAASB or the EU.

<sup>4</sup> <http://pcaobus.org/News/Speech/Pages/Harris-statement-transparency-12-15-15.aspx>

<sup>5</sup> <http://pcaobus.org/News/Speech/Pages/Doty-statement-transparency-12-15-15.aspx>

<sup>6</sup> <http://pcaobus.org/Rules/Rulemaking/Pages/Docket042.aspx>

the new rule and the proposed rule are designed to bring greater transparency to the identities of, and work performed by, the other firms that participate in the audit and the extent to which that work is being overseen and reviewed by the lead audit firm that is signing the audit report. Under current standards, the lead auditor is permitted to limit its involvement to certain specified procedures when using the work of other auditors.<sup>7</sup> Under the proposed rules issued by the PCAOB, the lead auditor would be required to conduct a risk-based analysis of the work of other auditors that is based upon, among other things, the risks of material misstatements and the knowledge, skill and ability of the other auditors. The proposal would amend existing requirements for determining the sufficiency of the lead auditor's participation to serve as the lead auditor to ensure it plays a meaningful role in the entire audit. In many cases, the PCAOB has observed through its inspection and enforcement activities that the lead auditor has either (i) inappropriately identified itself as the lead auditor (when a substantial portion of the financial statements were audited by another auditor) or (ii) failed to adequately assess the qualifications of other auditors' personnel who participated in the audit. Comments on the proposed rules regarding lead auditor supervision are due July 29, 2016.

### **Effective Date and Preparing for the New Rules**

The PCAOB has chosen a phased-in effective date. The new rules will take effect as follows: audit firms are required to file with the PCAOB on Form AP the name of the engagement partner for all public company audits issued on or after January 31, 2017. Information about other audit firms participating in the audit must be filed for all public company audits issued on or after June 30, 2017. Accordingly, the effective date for the disclosure of engagement partner names would apply to 2016 calendar year audits.

PCAOB-registered audit firms, especially those conducting multinational audits, should start collecting information early regarding the work conducted by the other firms participating in the audit so that the hours can be reported to the lead auditor, recognizing that some of the hours may have to be estimated for purposes of determining whether the 5 percent or more threshold is crossed. The new rules do not apply to broker-dealer audits.

PCAOB staff plans to publish additional guidance in 2016 to assist firms with the implementation requirements related to Form AP. Such guidance may address the following topics: (1) application of the filing requirements; (2) examples of computing total audit hours; and (3) illustrative language that may be included if an auditor chooses to voluntarily disclose information in the auditor's report about the engagement partner or other accounting firms that participated in the audit.

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<sup>7</sup> The PCAOB noted in its proposed rulemaking that about 55 percent of audits performed by US global network firms (GNFs) and about 30 percent of audits performed by non-US GNFs were engagements using other auditors. Additionally, according to research conducted by PCAOB staff, about 80 percent of the Fortune 500 issuer audits performed by US GNFs involved other auditors.