

investment company. By February 13, 2009, all shareholders of applicant had redeemed or exchanged their shares of applicant, based on net asset value. Applicant incurred no expenses in connection with the liquidation.

**Filing Dates:** The application was filed on September 3, 2009, and amended on September 9, 2009 and October 19, 2009.

**Applicant's Address:** 6803 S. Tucson Way, Centennial, CO 80112.

MetLife of CT Fund ABD II for Variable Annuities [File No. 811-7463]; MetLife of CT Separate Account Thirteen for Variable Annuities [File No. 811-21263]; MetLife of CT Separate Account PF for Variable Annuities [File No. 811-8313]; MetLife of CT Separate Account Eight for Variable Annuities [File No. 811-8907]; MetLife of CT Fund BD for Variable Annuities [File No. 811-8242]; MetLife of CT Separate Account TM for Variable Annuities [File No. 811-8477]; MetLife of CT Fund BD III for Variable Annuities [File No. 811-8225]; MetLife of CT Fund BD IV for Variable Annuities [File No. 811-8223]; MetLife of CT Separate Account QP for Variable Annuities [File No. 811-7487]; MetLife of CT Separate Account Nine for Variable Annuities [File No. 811-9411]; MetLife of CT Fund ABD for Variable Annuities [File No. 811-7465]; MetLife of CT Separate Account Fourteen for Variable Annuities [File No. 811-21267]; MetLife of CT Separate Account Six for Variable Annuities [File No. 811-8869]; MetLife of CT Fund U for Variable Annuities [File No. 811-3575]; MetLife Insurance Company of Connecticut Variable Annuity Separate Account 2002 [File No. 811-21220]; MetLife of CT Separate Account TM II for Variable Annuities [File No. 811-8479]; MetLife of CT Separate Account Five for Variable Annuities [File No. 811-8867]; MetLife and Annuity Company of Connecticut Variable Annuity Separate Account 2002 [File No. 811-21221]; MetLife of CT Separate Account Seven for Variable Annuities [File No. 811-8909]; MetLife of CT Separate Account Twelve for Variable Annuities [File No. 811-21266]; MetLife of CT Fund BD II for Variable Annuities [File No. 811-7259]; MetLife of CT Separate Account Ten for Variable Annuities [File No. 811-9413]; MetLife of CT Separate Account PF II for Variable Annuities [File No. 811-8317]

**Summary:** Each applicant seeks an order declaring that it has ceased to be an investment company. The board of directors of the applicants' depositor, MetLife Insurance Company of Connecticut ("MICC"), approved the merger of each applicant into MetLife of CT Separate Account Eleven for Variable Annuities on March 24, 2008. The mergers were effected on December 8, 2008. MICC bore all expenses relating to the mergers.

**Filing Date:** The applications were filed on August 24, 2009 and amended and restated on October 14, 2009.

**Applicants' Address:** 1300 Hall Boulevard, Bloomfield, CT 06002-2910.

MetLife of CT Variable Life Insurance Separate Account Two [File No. 811-7891]; MetLife of CT Variable Life Insurance Separate Account Three [File No. 811-8950]; MetLife of CT Fund UL II for Variable Life Insurance [File No. 811-7411]; MetLife of CT Variable Life Insurance Separate Account One [File No. 811-8952]

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**Filing Date:** The applications were filed on August 24, 2009 and amended and restated on October 14, 2009.

**Applicants' Address:** 1300 Hall Boulevard, Bloomfield, CT 06002-2910.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

**Florence E. Harmon,**

*Deputy Secretary.*

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**BILLING CODE P**

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-60903; File No. PCAOB-2009-02]

### Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Auditing Standard No. 7, Engagement Quality Review, and Conforming Amendment

October 29, 2009.

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on August 4, 2009, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission") the proposed rules described in Items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

#### I. Board's Statement of the Terms of Substance of the Proposed Rules

On July 28, 2009, the Board adopted Auditing Standard No. 7, Engagement Quality Review, and an amendment to the Board's Interim Quality Control Standards (collectively, "the proposed rules"). The text of the proposed rules text is set out below. Language that is

added by the amendment to the Board's Interim Quality Control Standards is italicized.

**Auditing Standard No. 7**  
*Supersedes SECPS Requirements of Membership § 1000.08(f).*

**Engagement Quality Review:**  
*Applicability of Standard:*

1. An engagement quality review and concurring approval of issuance are required for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB").

**Objective:**

2. The objective of the engagement quality reviewer is to perform an evaluation of 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 engagement report, if a report is to be issued, in order to determine whether to provide concurring approval of issuance.<sup>1</sup>

**Qualifications of an Engagement Quality Reviewer:**

3. The engagement quality reviewer must be an associated person of a registered public accounting firm. An engagement quality reviewer from the firm that issues the engagement report (or communicates an engagement conclusion, if no report is issued) must be a partner or another individual in an equivalent position. The engagement quality reviewer may also be an individual from outside the firm.<sup>2</sup>

4. As described below, an engagement quality reviewer must have competence, independence, integrity, and objectivity.

**Note:** The firm's quality control policies and procedures should include provisions to provide the firm with reasonable assurance that the engagement quality reviewer has sufficient competence, independence, integrity, and objectivity to perform the engagement quality review in accordance with the standards of the PCAOB.

<sup>1</sup> In the context of an audit, "engagement report" refers to the audit report (or reports if, in an integrated audit, the auditor issues separate reports on the financial statements and internal control over financial reporting). In the context of an engagement to review interim financial information, the term refers to the report on interim financial information. An engagement report might not be issued in connection with a review of interim financial information. See paragraph .03 of AU section ("sec.") 722, *Interim Financial Information*.

<sup>2</sup> An outside reviewer who is not already associated with a registered public accounting firm would become associated with the firm issuing the report if *he or she* (rather than, or in addition to, his or her firm or other employer): (1) Receives compensation from the firm issuing the report for performing the review or (2) performs the review as agent for the firm issuing the report. See PCAOB Rule 1001(p)(i) for the definition of an associated person of a registered public accounting firm.

## Competence

5. The engagement quality reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.<sup>3</sup>

## Independence, Integrity, and Objectivity

6. The engagement quality reviewer must be independent of the company, perform the engagement quality review with integrity, and maintain objectivity in performing the review.

**Note:** The reviewer may use assistants in performing the engagement quality review. Personnel assisting the engagement quality reviewer also must be independent, perform the assigned procedures with integrity, and maintain objectivity in performing the review.

7. To maintain objectivity, the engagement quality reviewer and others who assist the reviewer should not make decisions on behalf of the engagement team or assume any of the responsibilities of the engagement team. The engagement partner remains responsible for the engagement and its performance, notwithstanding the involvement of the engagement quality reviewer and others who assist the reviewer.

8. The person who served as the engagement partner during either of the two audits preceding the audit subject to the engagement quality review may not be the engagement quality reviewer. Registered firms that qualify for the exemption under Rule 2-01(c)(6)(ii) of Regulation S-X, 17 CFR 210.2-01(c)(6)(ii), are exempt from the requirement in this paragraph.

*Engagement Quality Review for an Audit:*

## Engagement Quality Review Process

9. In an audit engagement, the 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 engagement report. To evaluate such judgments and conclusions, the engagement quality

<sup>3</sup> The term "engagement partner" has the same meaning as the phrases "auditor with final responsibility for the audit" in AU sec. 311, *Planning and Supervision*, and "practitioner-in-charge of an engagement" in PCAOB interim quality control standard QC sec. 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. QC sec. 40 describes the competencies required of a practitioner-in-charge of an attest engagement.

reviewer should, to the extent necessary to satisfy the requirements of paragraphs 10 and 11: (1) Hold discussions with the engagement partner and other members of the engagement team, and (2) review documentation.

10. In an audit, the engagement quality reviewer should:

- a. Evaluate the significant judgments that relate to engagement planning, including—
  - The consideration of the firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process,
  - The consideration of the company's business, recent significant activities, and related financial reporting issues and risks, and
  - The judgments made about materiality and the effect of those judgments on the engagement strategy.
- b. Evaluate the engagement team's assessment of, and audit responses to—
  - Significant risks identified by the engagement team, including fraud risks, and
  - Other significant risks identified by the engagement quality reviewer through performance of the procedures required by this standard.

**Note:** A *significant risk* is a risk of material misstatement that is important enough to require special audit consideration.

c. Evaluate the significant judgments made about (1) the materiality and disposition of corrected and uncorrected identified misstatements and (2) the severity and disposition of identified control deficiencies.

d. Review the engagement team's evaluation of the firm's independence in relation to the engagement.

e. Review the engagement completion document<sup>4</sup> and confirm with the engagement partner that there are no significant unresolved matters.

f. Review the financial statements, management's report on internal control, and the related engagement report.

g. Read other information in documents containing the financial statements to be filed with the Securities and Exchange Commission ("SEC")<sup>5</sup> and evaluate whether the engagement team has taken appropriate

<sup>4</sup> Paragraph 13 of PCAOB Auditing Standard No. 3, *Audit Documentation*, requires the auditor to identify all significant findings or issues in an engagement completion document.

<sup>5</sup> See paragraphs .04-.06 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*; AU sec. 711, *Filings Under Federal Securities Statutes*.

action with respect to any material inconsistencies with the financial statements or material misstatements of fact of which the engagement quality reviewer is aware.

h. Based on the procedures required by this standard, evaluate whether appropriate consultations have taken place on difficult or contentious matters. Review the documentation, including conclusions, of such consultations.

i. Based on the procedures required by this standard, evaluate whether appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies.

## Evaluation of Engagement Documentation

11. In an audit, the engagement quality reviewer should evaluate whether the engagement documentation that he or she reviewed when performing the procedures required by paragraph 10—

a. Indicates that the engagement team responded appropriately to significant risks, and

b. Supports the conclusions reached by the engagement team with respect to the matters reviewed.

## Concurring Approval of Issuance

12. In an audit, the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care<sup>6</sup> the review required by this standard, he or she is not aware of a significant engagement deficiency.

**Note:** A *significant engagement deficiency* in an audit exists when (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

13. In an audit, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.<sup>7</sup>

<sup>6</sup> See AU sec. 230, *Due Professional Care in the Performance of Work*.

<sup>7</sup> Concurring approval of issuance by the engagement quality reviewer also is required when reissuance of an engagement report requires the auditor to update his or her procedures for subsequent events. In that case, the engagement quality reviewer should update the engagement quality review by addressing those matters related to the subsequent events procedures.

*Engagement Quality Review for a Review of Interim Financial Information:*

**Engagement Quality Review Process**

14. In an engagement to review interim financial information, the 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 engagement report, if a report is to be issued. To evaluate such judgments and conclusions, the engagement quality reviewer should, to the extent necessary to satisfy the requirements of paragraphs 15 and 16: (1) Hold discussions with the engagement partner and other members of the engagement team, and (2) review documentation.

15. In a review of interim financial information, the engagement quality reviewer should:

- a. Evaluate the significant judgments that relate to engagement planning, including the consideration of—
  - The firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process,
  - The company's business, recent significant activities, and related financial reporting issues and risks, and
  - The nature of identified risks of material misstatement due to fraud.

b. Evaluate the significant judgments made about (1) the materiality and disposition of corrected and uncorrected identified misstatements and (2) any material modifications that should be made to the disclosures about changes in internal control over financial reporting.

c. Perform the procedures described in paragraphs 10.d and 10.e.

d. Review the interim financial information for all periods presented and for the immediately preceding interim period, management's disclosure for the period under review, if any, about changes in internal control over financial reporting, and the related engagement report, if a report is to be issued.

e. Read other information in documents containing interim financial information to be filed with the SEC<sup>8</sup> and evaluate whether the engagement team has taken appropriate action with respect to material inconsistencies with the interim financial information or material misstatements of fact of which

the engagement quality reviewer is aware.

f. Perform the procedures in paragraphs 10.h and 10.i.

**Evaluation of Engagement Documentation**

16. In a review of interim financial information, the engagement quality reviewer should evaluate whether the engagement documentation that he or she reviewed when performing the procedures required by paragraph 15 supports the conclusions reached by the engagement team with respect to the matters reviewed.

**Concurring Approval of Issuance**

17. In a review of interim financial information, the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency.

**Note:** A significant engagement deficiency in a review of interim financial information exists when (1) the engagement team failed to perform interim review procedures necessary in the circumstances of the engagement, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

18. In a review of interim financial information, the firm may grant permission to the client to use the engagement report (or communicate an engagement conclusion to its client, if no report is issued) only after the engagement quality reviewer provides concurring approval of issuance.

**Documentation of an Engagement Quality Review:**

19. Documentation of an engagement quality review should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of this standard, including information that identifies:

- a. The engagement quality reviewer, and others who assisted the reviewer,
- b. The documents reviewed by the engagement quality reviewer, and others who assisted the reviewer,
- c. The date the engagement quality reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval.

20. Documentation of an engagement quality review should be included in the engagement documentation.

21. The requirements related to retention of and subsequent changes to audit documentation in PCAOB Auditing Standard No. 3, *Audit Documentation*, apply with respect to the documentation of the engagement quality review.

**Conforming Amendment to PCAOB Interim Quality Control Standards**

QC sec. 20, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice"

QC section ("sec.") 20, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice" of the Board's interim quality control standards is amended as follows—

The third sentence of paragraph .18 of QC sec. 20 is replaced with the following sentence:

*These policies and procedures also should address engagement quality reviews pursuant to PCAOB Auditing Standard No. 7, Engagement Quality Review.*

**II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules**

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

**A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules**

(a) Purpose

Section 103 of the Sarbanes-Oxley Act (the "Act") directs the Board, among other things, to set standards for public company audits, including a requirement for each registered public accounting firm to "provide a concurring or second partner review and approval of [each] audit report (and other related information), and concurring approval in its issuance \* \* \*."

As discussed more fully in Exhibit 3, the Board adopted Auditing Standard No. 7 because it believed that a well-performed engagement quality review ("EQR") can serve as an important safeguard against erroneous or insufficiently supported audit opinions and, accordingly, can contribute to audit quality. The proposed rules are intended to enhance the quality of the EQR by strengthening the existing

<sup>8</sup> See AU sec. 722.18f; AU sec. 711.

requirements. Auditing Standard No. 7 provides for a rigorous review that will serve as a meaningful check on the work performed by the engagement team and, the Board believes, should increase the likelihood that a registered public accounting firm will catch any significant engagement deficiencies before it issues its audit report. As a result, the Board recognizes that more work may be necessary under Auditing Standard No. 7 than was performed in some concurring reviews under the existing requirements.

Auditing Standard No. 7 requires the engagement quality reviewer (or the “reviewer”) to evaluate the significant judgments made and related conclusions reached by the engagement team in forming the overall conclusion on the engagement and in preparing the engagement report. Auditing Standard No. 7 also requires the engagement quality reviewer to perform certain procedures designed to focus the reviewer on those judgments and conclusions. The procedures required of the reviewer by Auditing Standard No. 7 are different in nature from the procedures required of the engagement team. Unlike the engagement team, a reviewer does not perform substantive procedures or obtain sufficient evidence to support an opinion on the financial statements or internal control over financial reporting. If more audit work is necessary before the reviewer may provide concurring approval of issuance, the engagement team—not the reviewer—is responsible under PCAOB standards for performing the work. In contrast, the reviewer fulfills his or her responsibility to perform an effective review of the engagement under the EQR standard by holding discussions with the engagement team, reviewing documentation, and determining whether he or she can provide concurring approval of issuance.

The proposed rules also amend the Board’s interim quality control standards by replacing the third sentence of paragraph .18 in QC section 20, “System of Quality Control for a CPA Firm’s Accounting and Auditing Practice” with a statement indicating that these policies and procedures also should address engagement quality reviews pursuant to PCAOB Auditing Standard No. 7.

#### (b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

#### *B. Board’s Statement on Burden on Competition*

The Board does not believe that the proposed rule changes will result in any

burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rule changes would apply equally to all registered public accounting firms.

#### *C. Board’s Statement on Comments on the Proposed Rules Received From Members, Participants or Others*

The Board released the proposed rules for public comment in PCAOB Release No. 2008–002 (February 26, 2008). The Board received 38 written comments. The Board considered these comments and made significant changes to the initial proposed rules. As a result, the Board again sought public comment in PCAOB Release No. 2009–001 (March 4, 2009). The Board received 30 written comment letters relating to its reproposal of the proposed rules. A copy of PCAOB Release Nos. 2008–002 and 2009–001 and the comment letters received in response to the PCAOB’s request for comment in both releases are available on the PCAOB’s Web site at [www.pcaobus.org](http://www.pcaobus.org).

The Board has carefully considered all comments it has received. In response to the written comments received on both the initial and reproposal of the proposed rules, the Board has clarified and modified certain aspects of the proposed rules, as discussed below.

#### *Overview of Auditing Standard No. 7:*

Overall, commenters preferred the repropose standard to the original proposal, though some continued to believe that certain provisions were unclear and suggested certain changes to the standard. After considering commenters’ feedback, the Board has made several modifications to the EQR standard to provide additional clarity. This section describes the comments received, the Board’s response, and changes made in AS No. 7.<sup>9</sup>

#### **Applicability of the EQR Requirement**

Paragraph 1 of the repropose standard required an EQR for audit engagements and reviews of interim financial information (“interim reviews”), but not for other engagements performed according to the standards of the PCAOB. For the most part, commenters believed that this provision was appropriate.<sup>10</sup> One commenter,

<sup>9</sup> The Board received some comments related to its standard-setting process in general. The Board continuously endeavors to improve its processes, including its standard-setting process, and is considering these comments as it does so.

<sup>10</sup> One commenter did not believe that an EQR should be required for interim reviews because of concerns about the scope of the EQR for interim reviews. The section entitled *Specifically Required*

however, suggested including the EQR requirements for interim reviews in AU section (“sec.”) 722, *Interim Financial Information*, instead of including them as part of the EQR standard to “make it clear that the scope of the procedures performed remain under the umbrella of the objective of a review of interim financial information (which is much different than the scope and objective of an audit).” Because the requirements for the EQR of interim reviews in AS No. 7 are closely related to and described by reference to the requirements for the EQR of an audit, the Board believes it is more appropriate to locate both sets of requirements in the same standard. Accordingly, the Board is adopting the provisions regarding applicability of the EQR standard as repropose.

#### **Statement of Objective**

The repropose standard included a statement of objective intended to focus reviewers on the overall purpose of the standard as they carry out the more specific EQR requirements. As repropose, the objective of the engagement quality reviewer was “to perform an evaluation of the significant judgments made by the engagement team and the conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report, if a report is to be issued, in order to determine whether to provide concurring approval of issuance.”

Most commenters agreed that the EQR standard should include a statement of objective. While some believed the objective was appropriate as repropose, several suggested substituting the phrase “related conclusions reached” for “the conclusions reached” to indicate that the reviewer is required to evaluate conclusions relating to significant judgments, rather than all conclusions. In addition, some commenters suggested making the objective less vague, while others wanted the Board to broaden it or make it less procedural.

After considering these comments, the Board has, as suggested by commenters, revised the objective so that it refers to “significant judgments made by the engagement team”<sup>11</sup> and the *related*

*Procedures in the EQR of an Interim Review* discusses the EQR requirements for interim reviews.

<sup>11</sup> Because the engagement partner has final responsibility for the engagement, he or she has final responsibility for the significant judgments made during the engagement, notwithstanding any involvement in or responsibility for those judgments by firm personnel outside of the engagement team, such as members of the firm’s national office. Accordingly the “significant judgments made by the engagement team” include

conclusions reached \* \* \* ." (emphasis added). This change should help reviewers maintain their focus on areas of the engagement that are most likely to contain a significant engagement deficiency. With this revision, the Board believes the statement of objective establishes, at the appropriate level of detail, a framework for the performance of the EQR that is consistent with the specific requirements in AS No. 7. Corresponding changes have been made in paragraphs 9 and 14, which describe the scope of the EQR for audits and interim reviews, respectively. The reviewer achieves his or her objective by complying with the specific requirements of the standard.

### Qualifications of the Engagement Quality Reviewer

In order to provide for a high-quality EQR, the repropoed standard described the qualifications that any reviewer would be required to meet. These provisions were designed to provide assurance that the reviewer could effectively perform an EQR of the particular engagement under review. At the same time, the provisions recognized that smaller firms may have few partners—and, in the case of sole practitioners, no additional partners—available in-house to perform the EQR.

Accordingly, the repropoed standard required an engagement quality reviewer from within the firm issuing the engagement report to be a partner or another individual in an equivalent position, but also allowed a qualified individual from outside the firm to perform the EQR. In either event, the repropoed standard required the reviewer to be an associated person<sup>12</sup> of a registered public accounting firm.<sup>13</sup>

all of the significant judgments made during the engagement.

<sup>12</sup> For clarity, in paragraph 3 of AS No. 7, the Board added a reference to Rule 1001(p)(i), which defines the term "associated person of a registered public accounting firm." A person not already associated with a registered firm can enter into a relationship with the firm issuing the report such that the person would become associated with that firm by performing the review. Specifically, a person not already associated with a firm would become associated with the firm issuing the report if *he or she* (rather than, or in addition to, his or her firm or other employer): (1) Receives compensation from the firm issuing the report for performing the review or (2) performs the review as agent for the firm issuing the report. For example, if the firm issuing the report contracts directly with an employee of an unregistered accounting firm to perform the engagement quality review, that person would become associated with the firm issuing the report by virtue of that independent contractor relationship.

<sup>13</sup> A registered public accounting firm has an obligation to secure and enforce consents to cooperate with the Board from each associated person of the firm, *see* Section 102(b)(3) of the Act, including those who become associated with the

The repropoed standard also included a general competence requirement and requirements related to the reviewer's independence, integrity, and objectivity.

#### *In-House Reviewer: Partner or an Individual in an Equivalent Position:*

The requirement in the repropoed standard for a reviewer from within the firm to be a partner or an individual in an equivalent position was intended to address concerns expressed by some commenters on the original proposal about the authority of the engagement quality reviewer relative to that of the engagement partner. Because the EQR is intended to be an objective second look at work performed by the engagement team, the reviewer should be able to withstand pressure from the engagement partner or other firm personnel, such as members of the firm's national office. As described in the repropoed release, the Board believed that concerns about authority will most often arise when the reviewer and the engagement partner work at the same firm. The Board also believed that a standard based on perceptions of relative authority within a firm would not be sufficiently clear to be workable. Accordingly, the Board attempted to address these concerns with a requirement that an in-house reviewer—but not one from outside the firm—be a partner or person in an equivalent position.

While some commenters supported the repropoed requirement, others disagreed with it, generally because, in their view, being a partner or person in an equivalent position would not necessarily ensure that the reviewer possesses the qualities required to perform the EQR. These commenters noted that partners as well as non-partners may be subject to internal pressure within the firm to provide concurring approval of issuance. In addition, in one commenter's view, it would be burdensome for one-partner firms to hire an outside reviewer to comply with this requirement. Finally, some commenters also asked the Board to define the term "equivalent position."

While both partners and non-partners may experience pressure within the firm to provide concurring approval of issuance, the Board continues to believe that the repropoed requirement is the most appropriate way to address this issue. Partnership is not a perfect proxy for authority, but a partner is more likely to possess sufficient authority to conduct the EQR than a non-partner.

firm by performing the review. The Board also may directly sanction any such person who fails to cooperate in an investigation or inspection. *See* Section 105(b)(3) of the Act and PCAOB Rules 5110 and 4006.

The Board continues to believe that a requirement based on perceptions of authority would not be workable. Accordingly, the Board is adopting this requirement substantially as repropoed.<sup>14</sup> At a firm that is not organized as a partnership, "an individual in an equivalent position" is someone with the degree of authority and responsibility of a partner in a firm that is organized as a partnership.

#### *Qualified Reviewer from Outside the Firm:*

As noted above, the repropoed standard also allowed a qualified reviewer from outside the firm to conduct the review. In the repropoed release, the Board expressed the view that allowing a sufficiently qualified professor or other individual not employed by an accounting firm to perform the EQR should not negatively affect audit quality and may mitigate the compliance burden on sole practitioners and smaller firms. The Board sought comment on whether a qualified accountant who is not employed by an accounting firm should be allowed to conduct the EQR.<sup>15</sup>

The majority of commenters on this topic did not oppose the repropoed provision. Some commenters, however, cautioned that reviewers from outside an accounting firm may not necessarily have the required technical expertise or recent audit experience. One commenter believed that allowing the use of such outside reviewers could "hamper the existing independence rules,"<sup>16</sup> increase costs, and limit the potential growth of partners.

After considering these comments, the Board continues to believe that the EQR standard can—and should—allow firms the proposed flexibility in choosing a reviewer, provided that reviewer meets the competence and other qualification requirements. According to these requirements, as discussed below, any reviewer would have to have the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the person

<sup>14</sup> One commenter suggested that the phrasing of the repropoed standard did not establish a requirement for the in-house reviewer to be a partner because it stated that the reviewer "may be" a partner, a person in an equivalent position, or an individual outside the firm. While the use of "may" in that context imposed a requirement, to avoid any confusion on this point the Board has rephrased the requirement in paragraph 3 of AS No. 7 to use the word "must."

<sup>15</sup> As noted in the repropoed release, under the existing requirement a firm may seek a waiver to engage an outside experienced individual to perform the EQR. Because AS No. 7 allows a firm to use an outside reviewer, such a waiver is not necessary under AS No. 7.

<sup>16</sup> The comment did not explain how the independence rules would be hampered.

who has overall responsibility for the engagement under review. Accordingly, while some persons from outside a firm might not have the required qualifications, those who do can effectively perform the EQR.<sup>17</sup>

The Board also does not agree that allowing the use of a reviewer from outside the firm issuing the report would negatively affect the application or enforcement of the independence rules. As the Board noted in the reproposing release, it will continue to consider anyone who performs the EQR to be an “audit partner” and a member of the “audit engagement team” for purposes of independence requirements.<sup>18</sup> In addition, because AS No. 7 would not require a firm to use an outside reviewer, allowing a firm to do so should not increase costs or limit the potential growth of partners. Any firm that is concerned that invoking the flexibility provided by the EQR standard would raise its costs or impede the development of its partners could, simply, decline to do so and use a reviewer from within the firm if one is available.

When considering an outside individual for the role of the engagement quality reviewer, the firm will likely need to make additional inquiries to obtain necessary information about the individual’s qualifications. For example, while information about independence of the firm’s partners is typically collected and evaluated as part of the periodic independence review, information about the independence of an outside reviewer will likely need to be requested and evaluated as part of the reviewer selection process. Firms also likely know more about the competence of their own partners than of an outside reviewer.

#### *General Competence Requirement:*

As noted above, the reproposed standard, like the original proposal, included a requirement for the reviewer to “possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the person who has overall responsibility for the same type of engagement.” This provision was intended to set a minimum requirement for those who would perform the EQR. In response to comments on the original proposal, the reproposing release explained that this provision, by its

<sup>17</sup> Similarly, a reviewer does not meet all of the qualification requirements in AS No. 7 by virtue of his or her status as a partner or employee of an accounting firm.

<sup>18</sup> See Rule 2–01(f) of Regulation S–X, 17 CFR 210.2–01(f), for the definitions of “audit partner” and “audit engagement team.”

terms, did not require the engagement quality reviewer’s knowledge and competence to match those of the engagement partner, or for the reviewer to be a “clone” of the engagement partner.<sup>19</sup>

Some commenters reiterated their concerns that the engagement quality reviewer’s skills would be expected to match those of the engagement partner, and that such a requirement could cause resource constraints for smaller firms. Other commenters suggested modifying the general competence provision by stating that the reviewer’s competence should be established based on the facts and circumstances of the engagement, or describing the required qualifications from the reviewer’s perspective, rather than by comparing them to the qualifications of the engagement partner. Finally, some commenters suggested including in the EQR standard a statement that the reviewer may obtain the required level of knowledge and competence through utilizing assistants.

The Board continues to believe that if a minimum level of knowledge and competence in accounting, auditing, and financial reporting is required to conduct an audit, it is similarly necessary to effectively review that audit.<sup>20</sup> The reviewer is not required to possess other competencies, e.g., those related to communication or management skills, that the engagement partner may have.

Accordingly, the Board is adopting the general competence provision substantially as proposed. The Board is, however, modifying the requirement to clarify further that the determination of what constitutes the appropriate level of knowledge and competence should be based on the circumstances of the engagement, including the size and complexity of the business under audit or under interim review.<sup>21</sup> In AS No. 7, the Board replaced the phrase “the same type of engagement” with “the engagement.” The new phrasing focuses the reviewer on the particular

<sup>19</sup> Specifically, the reproposing release noted:

The general competence provision merely sets a minimum requirement for those who would perform the EQR, but it does not require the reviewer’s competence to match that of the engagement partner. In many cases, both individuals’ competence will exceed the minimum level prescribed, but there is no requirement that they do so in tandem, or even at all.

<sup>20</sup> While a reviewer may use assistants in performing the EQR, the reviewer’s own skills should meet the requirements of AS No. 7.

<sup>21</sup> Footnote 18 on page 9 of the original release stated, “The determination of what constitutes the appropriate level of knowledge and competence should be based on the circumstances of the engagement, including the size or complexity of the business.”

engagement under review, rather than that “type” of engagement.<sup>22</sup> Firms that do not have partners that meet this general competence requirement available to perform the EQR may engage an outside reviewer to perform an EQR.

#### *Independence, Integrity, and Objectivity:*

Like the original proposal, the reproposed standard required the reviewer to be independent of the company, perform the review with integrity, and maintain objectivity. Comments on the reproposal focused on two provisions regarding objectivity—the prohibition against the reviewer supervising the engagement team and the two-year “cooling-off” period before the engagement partner could perform the EQR.

#### *Supervision of the Engagement Team:*

The reproposed standard provided that to maintain objectivity the engagement quality reviewer should not, among other things, “supervise the engagement team with respect to the engagement subject to the engagement quality review.” The phrase “subject to the engagement quality review” was intended to clarify that partners with leadership responsibilities in a firm, region, service, or industry practice are not, solely because of those responsibilities, precluded from reviewing any engagement performed by their subordinates in the firm. Some commenters believed that the phrase “subject to the engagement quality review” was not sufficient to clarify this point.

After considering these comments, the Board has decided that the express prohibition against “supervis[ing] the engagement team with respect to the engagement subject to the engagement quality review” is not necessary to effectuate the Board’s intent. The remaining two criteria for maintaining objectivity in paragraph 7 of AS No. 7—not making decisions on behalf of the engagement team and not assuming any responsibilities of the engagement team—are sufficient to preclude those involved in the engagement from

<sup>22</sup> In addition, to simplify the text of AS No. 7, the Board replaced the phrase “person with overall responsibility for the engagement” with the term “engagement partner.” Footnote 3 of AS No. 7 explains that the term “engagement partner” has the same meaning as the phrases the “auditor with final responsibility for the audit,” as described in AU sec. 311, *Planning and Supervision*, and the “practitioner-in-charge of an engagement,” as described in PCAOB interim quality control standard QC sec. 40, *The Personnel Management Element of a Firm’s System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. Because all of these terms refer to the same person, this change does not alter the meaning of the EQR standard.

serving as the engagement quality reviewer.<sup>23</sup> For example, partners (including the engagement partner and other partners on larger engagements), managers, and others who supervise engagement personnel on the audit under review would not qualify under the remaining criteria because they have assumed responsibilities of the engagement team. At the same time, removing the phrase “supervise the engagement team” from AS No. 7 should further clarify that those in leadership positions in the firm who did not make decisions for or assume responsibilities of the engagement team may perform the EQR.

#### *The Two-Year “Cooling-Off” Period:*

The repropoed standard included a provision prohibiting an engagement partner from serving as the engagement quality reviewer for at least two years following his or her last year as the engagement partner.<sup>24</sup> The Board included the “cooling-off” period because it believed that it would be harder for an engagement partner who has had overall responsibility for the audit for at least a year to perform the review with the necessary level of objectivity. While a number of commenters expressed general support for a two-year “cooling-off” period, some believed that it could impose an undue hardship on smaller firms, and suggested a shorter “cooling-off” period.

After considering these comments, the Board continues to believe that a “cooling-off” period will be beneficial to audit quality and that a two-year period appropriately safeguards objectivity without imposing unnecessary hardship on most firms. At the same time, the Board recognizes that compliance with this requirement could

<sup>23</sup> AS No. 7 does not prohibit the engagement team from consulting with the reviewer, as long as the reviewer maintains his or her objectivity in accordance with paragraph 7. As noted in the repropoed release, such consultations may contribute to audit quality. In addition, one commenter asked the Board to clarify whether a reviewer may consult with the same personnel who previously consulted with the engagement team. The EQR standard does not prohibit the reviewer from holding discussions with such personnel. The reviewer may not, however, use personnel who previously consulted with the engagement team as assistants in performing the review unless they meet the objectivity and other qualification requirements of AS No. 7. To emphasize the requirement that assistants maintain objectivity, the Board added to paragraph 7 of AS No. 7 the phrase “and others who assist the reviewer.”

<sup>24</sup> SEC independence rules allow engagement partners and concurring partners to serve for five consecutive years, after which they may not serve in either role for another period of five years. Within a five-year period, SEC independence rules do not impose a “cooling-off” period before the engagement partner can serve as the concurring partner. See Rule 2—01(c)(6)(i)(A) of Regulation S-X.

be difficult for smaller firms with fewer personnel. In its independence rules, the Securities and Exchange Commission (“SEC”) exempted certain smaller firms from the audit partner rotation requirements. Specifically, Rule 2—01(c)(6)(ii) of Regulation S-X provides an exemption for firms with fewer than five issuer audit clients and fewer than ten partners, provided the Board “conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence under” the SEC partner rotation requirements. The Board believes that this exemption—including the provision regarding Board inspections—also describes an appropriate exemption from the “cooling-off” requirement in the EQR standard. Accordingly, firms that qualify for the exemption from the SEC partner rotation requirements will also be exempt from the “cooling-off” period under AS No. 7.

#### **EQR Process**

The Board’s goal in proposing an EQR standard was to strengthen the existing requirements for concurring reviews in order to promote a more meaningful review of the work performed by the engagement team. Accordingly, the original proposal described certain procedures that the reviewer was required to perform that were more specific than those in the existing requirements. In response to comments received on the original proposal, the Board clarified some of the specifically required procedures and included, in a separate section in the repropoed standard, tailored requirements for an EQR of an interim review.

In general, commenters believed that the repropoed standard described the requirements of the EQR more clearly than the original proposal. However, a number of commenters suggested additional modifications that, in their view, would further clarify the Board’s intent and ensure consistency of the requirements with the statement of objective. As described below, after considering these comments, the Board has modified certain of these requirements.

#### *Terminology Used To Describe the Required Procedures*

Several commenters noted that the specifically required procedures in paragraphs 9, 10, 14, and 15 of the repropoed standard were described using different, but in some cases similar, terms such as “determine,” “evaluate,” “identify,” “read,” and “review,” which some commenters found confusing. In one commenter’s

view, the terms “determine,” “identify,” and “evaluate” may require the reviewer to perform procedures that are similar in scope to the procedures performed by the engagement partner. The commenters asked the Board to clarify the terminology in these sections of the EQR standard.

While the Board does not believe that this terminology required the reviewer to perform procedures that are appropriately performed by the engagement partner, it does agree that the terminology should not be confusing. Accordingly, the Board reduced the number of terms used in AS No. 7, so that the required procedures in paragraphs 9, 10, 14, and 15 are described using two terms, “evaluate” and “review”—with one exception. Because AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, requires the auditor to read other information in documents containing the financial statements to be filed with the SEC, paragraphs 10.g and 15.e of AS No. 7, like in the original and repropoed standards, also require the reviewer to read such other information and evaluate whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or interim financial information, respectively, or material misstatements of fact of which the engagement quality reviewer is aware.

#### *Review of Documentation:*

A number of commenters viewed the statement in paragraphs 9 and 14 of the repropoed standard that “the reviewer should perform the procedures \* \* \* by reviewing documentation” as too open-ended.<sup>25</sup> Commenters were concerned that this provision could be interpreted to require the review of all of the engagement documentation.

The Board did not intend to require—and the repropoed provision did not require—the reviewer to review all of the engagement documentation. Nevertheless, to clarify this point, the Board has added the phrase “to the extent necessary to satisfy the requirements” of paragraphs 10 and 11, in an EQR of an audit, and 15 and 16, in an EQR of an interim review. As a practical matter, the reviewer cannot comply with the requirements of the EQR standard without holding discussions with the engagement partner and reviewing documentation. AS No. 7 requires the reviewer to hold

<sup>25</sup> That statement was intended, along with other changes in the repropoed standard, to clarify that the EQR is a review of the engagement team’s work rather than a second audit. See page 17 of the repropoed release.

sufficient discussions with the engagement partner and other members of the engagement team and review sufficient documentation to perform the required procedures with due professional care. What is sufficient will necessarily depend on the facts and circumstances of the particular engagement under review. Auditors often document their significant judgments and conclusions in various summary documents, which could serve as a starting point for the reviewer's evaluation of the engagement team's work.

Paragraph 11 of the repropoed standard required the reviewer, in an EQR of an audit, to evaluate whether the engagement documentation that he or she reviewed when performing the procedures required by paragraph 10 indicates that the engagement team responded appropriately to significant risks and supports the conclusions reached by the engagement team with respect to the matters reviewed. One commenter suggested adding a requirement to paragraph 11 to evaluate engagement documentation for compliance with the requirements of Auditing Standard No. 3, *Audit Documentation* ("AS No. 3"). The Board originally proposed such a requirement but, in response to comments, did not include it in the repropoed standard.<sup>26</sup> The Board continues to believe that the documentation review requirements of paragraph 11 of the repropoed standard are appropriate and is adopting them as repropoed.

In an EQR of an interim review, paragraph 16 of the repropoed standard required the reviewer to evaluate whether the engagement documentation that he or she reviewed "[i]ndicates that the engagement team responded appropriately to significant risks," and "[s]upports the conclusions reached by the engagement team with respect to the matters reviewed." Some commenters noted that the auditor is not required to identify significant risks in a review of interim financial information and suggested not including a corresponding requirement in the EQR standard. The Board agrees and has not included this requirement in AS No. 7.

#### *Specifically Required Procedures in the EQR of an Audit:*

Like the original proposal, the repropoed standard required certain procedures designed to give the reviewer the necessary information to evaluate the engagement team's significant judgments and conclusions.

<sup>26</sup> Commenters suggested that such a requirement would duplicate the documentation review performed by the engagement partner.

In response to comments on the original proposal, the Board made changes to these provisions in the repropoed standard that were intended to clarify that the reviewer performs the EQR by reviewing the engagement team's work, rather than by auditing the company himself or herself. Some commenters suggested that the specifically required procedures in the repropoed standard needed additional clarification.

In the view of several commenters, the repropoed standard did not clearly articulate the requirement for the reviewer to focus on the significant judgments made and the related conclusions reached by the engagement team. These commenters believed that the repropoed standard might be interpreted as requiring the review of all of the engagement team's judgments and conclusions. In response, AS No. 7 refers to "significant judgments" instead of "judgments" in describing certain of the required procedures.

The Board also clarified the wording of paragraph 10.b of the repropoed standard, which required the reviewer to "evaluate the risk assessments and audit responses. \* \* \*" Some commenters expressed concern that this formulation required a review of audit responses for all areas of the audit. In response, AS No. 7 more specifically requires the reviewer to evaluate the engagement team's audit responses to significant risks identified by the engagement team and other significant risks identified by the engagement quality reviewer through performance of the procedures required by the EQR standard.<sup>27</sup> This change should help focus reviewers on areas of the audit that are more likely to contain a significant engagement deficiency.

Some commenters also expressed concern about the requirements in paragraphs 10.e and 10.f of the repropoed standard to determine whether appropriate matters have been communicated to the audit committee, management, and others; and to determine whether appropriate consultations have taken place on

<sup>27</sup> The term "significant risk" is defined in the Board's recently proposed auditing standard on identifying and assessing risks of material misstatement to mean a "risk of material misstatement that is important enough to require special audit consideration." PCAOB Release No. 2008-006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards* (October 21, 2008). The Board intends that definition to apply to the EQR standard as well. The Board included this definition in a note to paragraph 10.b of AS No. 7. If, at the conclusion of the above mentioned rulemaking, the Board adopts a definition of significant risk that is different from that proposed, the Board will make a conforming change to the EQR standard.

difficult or contentious matters. According to these commenters, a requirement to determine whether all of the communications or consultations have taken place rather than to evaluate the engagement team's communications and consultations was inconsistent with the objective of the EQR. In response, the Board replaced the phrase "determine if" with "based on the procedures required by this standard, evaluate whether." This change should tailor the specific requirements more closely to the overall objective. The Board also placed these paragraphs after the other required procedures in paragraph 10 to emphasize that the reviewer performs the evaluation required by these paragraphs based on the information obtained through the other procedures required by the EQR standard, and made a corresponding change in paragraph 15 for the EQR of an interim review.

#### *Specifically Required Procedures in the EQR of an Interim Review:*

In response to comments on the original proposal, the Board included in the repropoed standard separate requirements for reviewing audits and interim reviews. The EQR requirements for interim reviews were based on the requirements for an EQR of an audit but were tailored to the different procedures performed in an interim review. A number of commenters were supportive of including separate requirements for the EQR of interim reviews in the repropoed standard. Some commenters, as discussed below, suggested modifications to those requirements.

Paragraph 15.a of the repropoed standard required the evaluation of engagement planning, including the consideration of the firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process; the company's business, recent significant activities, and related financial reporting issues and risks; and the nature of identified risks of material misstatement due to fraud. In one commenter's view, that paragraph might suggest that an interim review should include the same type of risk assessment as an audit. After considering this comment, the Board disagrees. Paragraph 15.a does not impose a requirement on the engagement team to identify risks as part of an interim review. Rather, it requires the reviewer to evaluate the engagement team's consideration of risks that have already been identified, e.g., during the preceding year's audit.



Additionally, three commenters recommended not requiring the EQR of an interim review to include an evaluation of judgments made about the severity and disposition of identified control deficiencies. In one commenter's view, such an evaluation would be inconsistent with the scope of an interim review. AU sec. 722.07, provides that the auditor:

should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

In response, the Board modified the requirement in paragraph 15.b in AS No. 7 to be more consistent with the requirements of AU sec. 722.

Accordingly, AS No. 7 requires the reviewer, among other things, to evaluate significant judgments made about any material modifications that should be made to the disclosures about changes in internal control over financial reporting.

Paragraph 15.c of the reproposed standard required the reviewer, in the EQR of an interim review, to "[r]ead the interim financial information for all periods presented and for the immediately preceding interim period, management's disclosure for the period under review, if any, about changes in internal control over financial reporting, and the related engagement report, if a report is to be filed with the SEC." Some commenters suggested that the reviewer should be required to read the engagement report even when the issuer is not required to include the report in an SEC filing. The Board agrees and, accordingly, changed "to be filed with the SEC" to "to be issued."<sup>28</sup>

### Concurring Approval of Issuance

For an EQR of an audit, paragraph 12 of the reproposed standard provided that the reviewer "may provide concurring approval of issuance only if,

<sup>28</sup> Additionally, one commenter recommended not requiring the reviewer to read interim financial information "for the immediately preceding interim period" because it was not clear, to this commenter, what one would review when performing the EQR for the first quarter. AU sec. 722.16 requires the accountant to apply analytical procedures to the interim financial information, which should include, among other things, comparing the quarterly interim financial information with comparable information for the immediately preceding interim period (i.e., the fourth quarter of the prior year, in a first quarter interim review). Because the Board believes the reproposed requirement is appropriately within the scope of an EQR for an interim review, it has retained it in AS No. 7.

after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency." A note to the same paragraph describes a "significant engagement deficiency" as any of the four conditions described in the original proposal.<sup>29</sup> The reproposed requirements for providing concurring approval of issuance in an EQR of an interim review were the same, except that the first of these four conditions was modified in light of the differences between an interim review and an audit. Specifically, in an EQR of an interim review, the first condition was "the engagement team failed to perform interim review procedures necessary in the circumstances of the engagement" rather than "the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB."

Commenters generally believed that the concurring approval of issuance provision was appropriately described, though one recommended excluding the reference to "due professional care" from the EQR standard because AU sec. 230, *Due Professional Care in the Performance of Work*, already imposes an overall requirement on auditors to exercise due professional care. Many commenters, however, were critical of the reproposing release's description of the reproposed requirement. A significant number of commenters objected to, or stated that they disagreed with, the statement in the reproposing release that the requirement to exercise due professional care imposes on the engagement quality reviewer essentially the same requirement as the "knows, or should know based on the requirements of this standard" formulation that was originally proposed. Some suggested that the Board is redefining the meaning of due professional care. One commenter stated that "[a] standard of 'knows, or should know' is akin to a strict liability requirement for engagement deficiencies," while another commenter suggested that the Board "clarify that in this context, 'due professional care' is not a negligence standard."

After considering the comments, the Board is adopting the concurring approval of issuance requirement as reproposed. While auditors are already

<sup>29</sup> As included in the reproposed standard, these conditions were: (1) The engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB; (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement; (3) the engagement report is not appropriate in the circumstances; or (4) the firm is not independent of its client.

required to exercise due professional care in discharging their responsibilities, comments, as noted above and in the reproposing release, have reflected some confusion about the applicable standard of care in an EQR. Accordingly, reference to due professional care in the requirement is appropriate.

The Board is not redefining due professional care in the context of the EQR standard. As the Board noted in the reproposing release, AU sec. 230 describes due professional care as "reasonable care and diligence" and makes clear that an auditor who acts negligently, i.e., without "reasonable care and diligence," breaches the duty to exercise due professional care.<sup>30</sup> Due professional care, as described in AU sec. 230, imposes neither a strict liability nor an actual knowledge standard. The Board intends the term to mean "reasonable care and diligence," as described in AU sec. 230.

The application of a negligence standard to the concurring approval of issuance provision means, as noted in the reproposing release, that "a reviewer cannot evade responsibility because, as a result of an inadequate review, he or she did not discover a problem that a reasonably careful and diligent review would have revealed."<sup>31</sup> For that reason, the provision requires the reviewer to perform the required review with due professional care as a prerequisite to providing concurring approval of issuance. A qualified reviewer who has done so will, necessarily, have discovered any significant engagement deficiencies that could reasonably have been discovered under the circumstances. Accordingly, under AS No. 7, such a reviewer may provide concurring approval of issuance if "he or she is not aware of a significant engagement deficiency." Because a reviewer who has not performed the required review with due professional care might not have discovered any significant engagement deficiencies that could reasonably have been discovered under the circumstances—i.e., those the reviewer reasonably should know about—such a reviewer may not,

<sup>30</sup> See AU sec. 230.03.

<sup>31</sup> Of course, to impose the more severe sanctions authorized under the Act, such as a permanent bar or permanent revocation of registration, the Board must establish "(A) intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard; or (B) repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." Section 105(c)(5) of the Act; see also Rules on Investigations and Adjudications, PCAOB Release No. 2003-015, Appendix 2 at A2-76 (September 29, 2003) (discussing Section 105(c)(5)).

consistent with the standard, provide concurring approval of issuance.

### Documentation of the EQR

The repropoed standard required the EQR documentation to contain sufficient information to identify: who performed the review, the documents reviewed, whether and when concurring approval of issuance was provided or the reasons for not providing the approval, and the significant discussions held, including the details of such discussions. These provisions were intended to respond to comments expressing concern that the originally proposed documentation requirements were overly detailed and would result in duplication of the engagement team's work. Some commenters reiterated their concerns that some of the repropoed requirements were duplicative of requirements to document the engagement itself or overly burdensome.

The Board continues to believe that it is necessary to strengthen the documentation requirements in the interim standard to provide for an informative record of the work performed during the EQR. At the same time, the Board has reconsidered its approach to the documentation requirement in light of the comments received. As described below, the Board has added a general requirement that places the specific requirements in the context of the overall purpose of EQR documentation—to provide a record of how the reviewer carried out the review in accordance with the standard's requirements.

Specifically, paragraph 19 of AS No. 7 includes a requirement for the engagement documentation to contain sufficient information to enable an experienced auditor,<sup>32</sup> having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of the standard.<sup>33</sup> This provision is similar to the audit documentation requirement in paragraph 6 of AS No. 3, and should clarify how the more specific requirements are meant to apply in particular circumstances.

For example, if a reviewer identified a significant engagement deficiency to

be addressed by the engagement team, the engagement team should document its response to the identified deficiency in accordance with AS No. 3. Because AS No. 7 does not require duplication of documentation prepared by the engagement team, the engagement quality reviewer does not have to separately document the engagement team's response. Rather, the EQR documentation should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand, *e.g.*, the significant deficiency identified, how the reviewer communicated the deficiency to the engagement team, why such matter was important, and how the reviewer evaluated the engagement team's response. Similarly, if the reviewer participated in the discussion of the potential for material misstatement due to fraud,<sup>34</sup> and the engagement team documented the discussion in accordance with AS No. 3, AS No. 7 only requires the engagement quality reviewer or reviewer's assistants to prepare separate documentation if the documentation prepared by the engagement team does not contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of AS No. 7.

In response to comments, the Board also considered whether modifications were necessary to the specific requirements. First, the Board received several comments related to the provisions of repropoed paragraph 19.b, which required the EQR documentation to contain information sufficient to identify the documents reviewed. One commenter believed that a reviewer "may feel compelled to engage in an unnecessary review of additional documents in order to compile a more 'complete' list." Conversely, another commenter believed that the reviewer would be discouraged "to inspect one or more documents than he or she otherwise might or should, thus reducing the quality of the EQR." Some commenters suggested clarifying how the documents should be identified as "reviewed" (*i.e.*, electronically or manually), or suggested limiting the scope of paragraph 19.b to "significant documents."

After considering these comments, the Board has decided to include this requirement in AS No. 7. Identifying a document as reviewed by the engagement quality reviewer should not be unduly burdensome, and will provide an informative record. Such a record could provide registered firms, and the Board, with better information about the EQR, which can be used to evaluate and improve the EQR process. The Board believes it is unnecessary to require in the standard a particular document identification method, such as electronic or manual signature. Rather, this should be determined by each firm individually.

Second, a number of commenters believed that the requirement in paragraph 19.c to document details of significant discussions held by the reviewer, and others who assisted the reviewer, would not improve audit quality and that it would be costly to implement. These commenters suggested that the reviewer might not be able to determine whether a discussion is significant at the time a discussion is held and therefore feel compelled to document every discussion. In order to make clear that documentation of every discussion is neither required nor a prudent use of resources, the Board has not included an explicit requirement to document discussions in AS No. 7. As explained above, however, if documentation of a particular discussion is necessary "to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed \* \* \* to comply with the provisions of th[e] standard," such documentation is required under the general documentation requirement.

### Effective Date

In repropoing the standard, the Board intended to make a final standard effective for EQRs of interim reviews for fiscal years beginning after December 15, 2009 and for EQRs of audits for fiscal years ending on or after December 15, 2009. Several commenters were concerned that the proposed effective date would not allow for sufficient time to train the auditing firm's personnel and implement the new EQR requirements. These commenters recommended that the effective date of the EQR standard be linked to the beginning of an audit period to provide adequate time for registered firms to prepare for adoption. The Board agrees with the concerns expressed by the commenters and has decided to make AS No. 7 effective, subject to SEC approval, for both the EQR of audits and the EQR of interim reviews for fiscal

<sup>32</sup> As described in paragraph 6 of AS No. 3, "[a]n experienced auditor has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry."

<sup>33</sup> Additionally, for clarity of presentation, the Board moved the requirement to include documentation of an EQR in the engagement documentation from paragraph 19 to a new paragraph 20 in AS No. 7.

<sup>34</sup> See paragraph .14 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

years beginning on or after December 15, 2009.

### Comparison With Other EQR Standards

Three commenters suggested that the Board provide a comparison between the EQR standard and standards of other standard-setters on this subject. One commenter noted that because issuer clients often represent a minor part of a smaller firm's audit client base, the audit methodology of such a firm may be based on other standards as well as PCAOB standards. In response, the Board has described certain significant differences between the Board's EQR standard and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB")<sup>35</sup> and the Auditing Standards Board ("ASB") of the AICPA.<sup>36</sup>

This comparison is provided for informational purposes only and may not represent the views of the ASB or IAASB regarding the interpretation of their standards. It describes only certain provisions of AS No. 7, and is not a substitute for the EQR standard itself. Compliance with AS No. 7 is required for registered public accounting firms. Compliance with the analogous ASB and IAASB standards is not sufficient to meet the requirements of AS No. 7.

The Board has developed AS No. 7 to enhance the quality of the engagement quality review ("EQR") process by strengthening the provisions of the Board's interim standard.<sup>37</sup> Recently, the ASB and IAASB also updated their standards related to the EQR, and the Board considered information in the standards of the ASB and IAASB when developing its new EQR standard. As described in this section, AS No. 7 includes provisions that are similar in terminology and substance to those in the ASB and IAASB standards, and other provisions added as necessary by the Board. For example, the Board included certain provisions in AS No. 7 that are not included in the standards of the ASB or IAASB to: Comply with the requirements of the Act; respond to the feedback received on the interim standard from the Board's Standing

<sup>35</sup> International Standard on Quality Control 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, and International Standard on Auditing 220, *Quality Control for an Audit of Financial Statements*, issued in December 2008.

<sup>36</sup> AICPA, Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control* (October 2007).

<sup>37</sup> The Securities and Exchange Commission Practice Section ("SECP") of the AICPA Requirements of Membership Sections 1000.08(f); 1000.39, Appendix E.

Advisory Group ("SAG") and information obtained through PCAOB oversight of registered firms; and to ensure consistency of the provisions of AS No. 7 with the provisions and terminology of other relevant standards of the PCAOB.

Some of the provisions of the IAASB standards described in this section are included in the "Application and Other Explanatory Material" section of these standards. That section "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA."<sup>38</sup> In contrast, the comparable provisions of AS No. 7 are included in the standard, and establish requirements.

### Applicability

#### PCAOB

Section 103 of the Act requires the Board to adopt an EQR standard for audit engagements.<sup>39</sup> Because of the importance of interim financial information to investors, the Board has decided to include a requirement to perform an EQR for reviews of interim financial information performed in accordance with AU section ("sec.") 722, *Interim Financial Information*, ("interim reviews") in the EQR standard. Accordingly, AS No. 7 requires an EQR and concurring approval of issuance for each audit engagement and for each interim review engagement conducted pursuant to the standards of the PCAOB.<sup>40</sup>

#### ASB

SQCS No. 7 does not require an EQR for any type of engagement. Accounting firms should determine whether an EQR is required for any engagement.<sup>41</sup>

#### IAASB

ISQC 1 requires an EQR only for audits of financial statements of listed entities. Accounting firms should determine whether an EQR is required for any other engagements.<sup>42</sup>

### Qualifications of a Reviewer

#### PCAOB

*Associated Person*—In order to obtain cooperation with the Board of the individuals that perform an EQR,<sup>43</sup> the

Board included in AS No. 7 a requirement, according to which the engagement quality reviewer must be an associated person of a registered public accounting firm.<sup>44</sup>

*A Reviewer from Outside the Firm*—Similar to the standards of the ASB and IAASB, AS No. 7 allows a qualified individual from outside the firm to perform an EQR.<sup>45</sup>

*Partner or Person in an Equivalent Position*—Because the EQR is intended to be an objective "second look" at work performed by the engagement team, the reviewer should possess sufficient authority to be able to withstand pressure from the engagement partner or other firm personnel, such as members of the firm's national office. The Board believes that concerns about authority will most often arise when the reviewer and the engagement partner are from the same firm. Therefore, the Board included in AS No. 7 the requirement that an in-house reviewer—but not one from outside the firm—be a partner or another individual in an equivalent position.<sup>46</sup>

*General Competence Requirement*—The Board included in AS No. 7 a requirement for the reviewer to possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.<sup>47</sup> Without such knowledge and competence, the reviewer would not be able to appropriately evaluate the significant judgments made and related conclusions reached by the engagement team in an audit or an interim review.

*Independence, Integrity, and Objectivity*—The reviewer must comply with all applicable independence requirements,<sup>48</sup> and perform the review

including those who become associated with the firm by performing the review. The Board also may directly sanction any such person who fails to cooperate in an investigation or inspection. See Section 105(b)(3) of the Act and PCAOB Rules 5110 and 4006.

<sup>44</sup> See paragraph 3 of AS No. 7.

<sup>45</sup> See *id.*

<sup>46</sup> See *id.*

<sup>47</sup> See paragraph 5 of AS No. 7. PCAOB interim quality control standards describe the competencies required of a person who has the overall responsibility for an engagement (or any practitioner-in-charge of an attest engagement). See QC sec. 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement*.

<sup>48</sup> See, e.g., Rule 2-01(c)(6) of Regulation S-X, 17 CFR 210.2-01(c)(6) (subjecting the engagement quality reviewer to the five-year partner rotation requirement).

<sup>38</sup> See paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

<sup>39</sup> See Section 103(a)(2)(A)(ii) of the Act.

<sup>40</sup> See paragraph 1 of AS No. 7.

<sup>41</sup> See paragraphs 80-81 and 83 of SQCS No. 7.

<sup>42</sup> See paragraphs 35(a)-(b) of ISQC 1.

<sup>43</sup> A registered public accounting firm has an obligation to secure and enforce consents to cooperate with the Board from each associated person of the firm, see Section 102(b)(3) of the Act,

with integrity and objectivity.<sup>49</sup> The engagement quality reviewer should be able to take a step back and conduct the review from the perspective of an outsider looking in.

Accordingly, AS No. 7 requires that the firm's quality control policies and procedures should include provisions to provide the firm with reasonable assurance that the engagement quality reviewer has sufficient competence, independence, integrity, and objectivity to perform the engagement quality review in accordance with the standards of the PCAOB.<sup>50</sup> As described later, the ASB and IAASB contain similar provisions, except the standards of IAASB do not include the direction on independence for the reviewer.

While AS No. 7 does not contain the direction included in the standards of ASB and IAASB that the firm's policies and procedures should establish the degree to which a reviewer can be consulted on the engagement without compromising his or her objectivity,<sup>51</sup> or provide for the replacement of the reviewer when the reviewer's ability to perform an objective review has been, or may be, impaired,<sup>52</sup> such direction is implicit in the requirement of AS No. 7 that a reviewer must maintain objectivity in performing the EQR.<sup>53</sup> Importantly, AS No. 7 provides direction on maintaining objectivity, according to which the engagement quality reviewer and others who assist the reviewer should not make decisions on behalf of the engagement team or assume any of the responsibilities of the engagement team.<sup>54</sup>

*"Cooling-off" period*—An engagement quality reviewer is expected to take a fresh, objective look at the engagement. The Board believes that it would be harder for an engagement partner, who has had overall responsibility for the audit for a year or more, to perform the EQR with the necessary level of objectivity. Accordingly, AS No. 7 includes a requirement, according to which the reviewer may not be the person who served as the engagement partner during either of the two audits preceding the audit subject to the EQR. (Registered firms that qualify for the exemption under Rule 2-01(c)(6)(ii) of Regulation S-X, 17 CFR 210.2-

01(c)(6)(ii), are exempt from this requirement.)<sup>55</sup>

#### ASB

SQCS No. 7 requires an auditing firm to establish the engagement quality reviewer qualifications, including those related to experience, authority, and objectivity.<sup>56</sup> SQCS No. 7 describes the engagement quality reviewer as a partner, other person in the firm, qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to perform the EQR.<sup>57</sup> According to SQCS No. 7, what constitutes sufficient and appropriate technical experience, and authority depends on the circumstances of the engagement.<sup>58</sup>

SQCS No. 7 does not include a "cooling-off" period, or a requirement for the reviewer to be an associated person of a registered public accounting firm.

Similar to AS No. 7, SQCS No. 7 requires that the firm establish policies and procedures designed to maintain the objectivity of the reviewer, and that such policies and procedures provide that the reviewer should satisfy the independence requirements relating to the engagements reviewed.<sup>59</sup> Unlike AS No. 7, SQCS No. 7 does not provide a specific direction on maintaining objectivity. Instead, SQCS No. 7 provides examples of policies and procedures for maintaining the objectivity of the reviewer.<sup>60</sup>

#### IAASB

ISQC 1 requires an auditing firm to establish the engagement quality reviewer qualification requirements, including those related to experience, authority, and objectivity.<sup>61</sup> The engagement quality reviewer is described as a partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the report.<sup>62</sup> The application materials in ISQC 1 state that what constitutes sufficient and

appropriate technical expertise, experience and authority depends on the circumstances of the engagement.<sup>63</sup>

ISQC 1 and ISA 220 do not include reviewer independence or "cooling-off" requirements, or a requirement for the reviewer to be an associated person of a registered public accounting firm.

Similar to AS No. 7, ISQC 1 requires that the firm establish policies and procedures designed to maintain the objectivity of the reviewer.<sup>64</sup> Unlike AS No. 7, the IAASB standards do not provide specific direction on maintaining objectivity. Instead, the application materials of ISQC 1 discuss policies and procedures for maintaining the objectivity of the reviewer.<sup>65</sup>

#### *Engagement Quality Review for an Audit:*

#### **Engagement Quality Review Process**

##### *PCAOB*

Similar to the standards of the ASB and IAASB, AS No. 7 requires the reviewer to evaluate the significant judgments made and the related conclusions reached by the engagement team in forming the overall conclusion on the engagement and in preparing the engagement report; and to carry out the review through discussions with those performing the engagement and the review of documentation.<sup>66</sup>

Further, AS No. 7 specifically requires the reviewer, among other things, to evaluate:

- The significant judgments that relate to engagement planning;<sup>67</sup>
- The engagement team's assessment of and audit responses to significant risks, including fraud risks;<sup>68</sup> and
- The significant judgments made about identified misstatements and control deficiencies.<sup>69</sup>

Also, AS No. 7 contains a requirement, similar to a requirement for audits of listed entities in ISA 220, according to which the reviewer, based on the procedures required by the standard, should evaluate whether appropriate consultations have taken place on difficult or contentious matters, and review the documentation, including conclusions, of such consultations.<sup>70</sup>

According to PCAOB Rule 3520, *Auditor Independence*, "[a] registered

<sup>49</sup> See ET sec. 102, *Integrity and Objectivity*, and ET sec. 191, *Ethics Rulings on Independence, Integrity, and Objectivity*.

<sup>50</sup> See paragraph 4 of AS No. 7.

<sup>51</sup> See paragraph 96 of SQCS No. 7; paragraph 39(b) of ISQC 1.

<sup>52</sup> See paragraph 97 of SQCS No. 7; paragraph 41 of ISQC 1.

<sup>53</sup> See paragraph 6 of AS No. 7.

<sup>54</sup> See paragraph 7 of AS No. 7.

<sup>55</sup> See paragraph 8 of AS No. 7.

<sup>56</sup> See paragraphs 92-94 of SQCS No. 7.

<sup>57</sup> See paragraph 5.e of SQCS No. 7.

<sup>58</sup> See paragraph 93 of SQCS No. 7.

<sup>59</sup> See paragraph 94 of SQCS No. 7.

<sup>60</sup> See paragraph 95 of SQCS No. 7.

<sup>61</sup> See paragraphs 39 and 40 of ISQC 1.

<sup>62</sup> See paragraph 12(e) of ISQC 1; paragraph 7(c) of ISA 220.

<sup>63</sup> See paragraph A47 of the Application and Other Explanatory Materials of ISQC 1.

<sup>64</sup> See paragraph 40 of ISQC 1.

<sup>65</sup> See paragraph A49 of the Application and Other Explanatory Materials of ISQC 1.

<sup>66</sup> See paragraph 9 of AS No. 7.

<sup>67</sup> See paragraph 10.a of AS No. 7.

<sup>68</sup> See paragraph 10.b of AS No. 7.

<sup>69</sup> See paragraph 10.c of AS No. 7.

<sup>70</sup> See paragraph 10.h of AS No. 7.

public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period." Because of the importance of compliance with PCAOB and SEC independence requirements, AS No. 7 requires the reviewer to review the engagement team's evaluation of the firm's independence in relation to the engagement.<sup>71</sup>

In 2004, the Board adopted Auditing Standard No. 3, *Audit Documentation* ("AS No. 3"). According to paragraph 13 of AS No. 3, the auditor must identify all significant findings or issues in an engagement completion document. AS No. 7 requires the reviewer to review the engagement completion document and confirm with the person who has overall responsibility for the engagement that there are no significant unresolved matters.<sup>72</sup>

Similar to the standards of the ASB and IAASB, AS No. 7 requires the reviewer to review the financial statements and the related engagement report.<sup>73</sup> Additionally, because an integrated audit includes an audit of internal control over financial reporting,<sup>74</sup> AS No. 7 requires the reviewer to review management's report on internal control.<sup>75</sup>

An issuer may publish various documents that contain information in addition to audited financial statements and the auditor's report thereon. The auditor is required to read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.<sup>76</sup> Accordingly, AS No. 7 requires the reviewer to read other information in documents containing the financial statements to be filed with the SEC and evaluate whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or material misstatements of fact of which the engagement quality reviewer is aware.<sup>77</sup>

Finally, because of the importance to the audit process of effective communication between the auditor and those charged with governance, AS No. 7 requires the reviewer, based on the procedures required by the standard, to evaluate whether appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies.<sup>78</sup>

#### ASB

Similar to AS No. 7, SQCS No. 7 requires that the EQR procedures include an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report.<sup>79</sup> The EQR performed in accordance with SQCS No. 7 should include: reading the financial statements or other subject matter information and the report and considering whether the report is appropriate; review of selected documentation; and a discussion with the engagement partner regarding significant findings and issues.<sup>80</sup>

In addition to the required procedures summarized in the preceding paragraph, an EQR performed in accordance with SQCS No. 7 may include consideration of certain other matters, examples of which are provided in the standard. SQCS No. 7 also provides examples of significant judgments that could be made by the engagement team.<sup>81</sup>

#### IAASB

The EQR procedures required by the standards of the IAASB are similar to those required by the ASB.<sup>82</sup> Additionally, for audits of listed entities, the IAASB standards require the reviewer to consider: the engagement team's evaluation of the firm's independence in relation to the engagement; and whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.<sup>83</sup>

### Evaluation of Engagement Documentation

#### PCAOB

AS No. 7 includes a documentation review requirement that is similar to the requirement for audits of listed entities

in the IAASB standards. According to AS No. 7, the reviewer should evaluate whether the engagement documentation that he or she reviewed when performing the required EQR procedures indicates that the engagement team responded appropriately to significant risks and supports the conclusions reached by the engagement team with respect to the matters reviewed.<sup>84</sup>

#### ASB

Unlike AS No. 7, SQCS No. 7 does not require the reviewer to evaluate whether the engagement documentation satisfies certain criteria. Instead, SQCS No. 7 states that an EQR may include consideration of whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.<sup>85</sup>

#### IAASB

Similar to AS No. 7, the IAASB standards require, for audits of financial statements of listed entities, that the reviewer consider whether audit documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached.<sup>86</sup>

### Concurring Approval of Issuance and Resolution of Differences of Opinion

#### PCAOB

Under the Act,<sup>87</sup> the Board's standard on EQR must require concurring approval of issuance of each audit report. AS No. 7 states that the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the review required by the standard, he or she is not aware of a significant engagement deficiency.<sup>88</sup> The firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.<sup>89</sup>

Unlike the standards of the ASB and IAASB, AS No. 7 does not include an

<sup>71</sup> See paragraph 10.d of AS No. 7.

<sup>72</sup> See paragraph 10.e of AS No. 7.

<sup>73</sup> See paragraph 10.f of AS No. 7.

<sup>74</sup> PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* establishes requirements and provides direction that apply when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting.

<sup>75</sup> See paragraph 10.f of AS No. 7.

<sup>76</sup> See AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

<sup>77</sup> See paragraph 10.g of AS No. 7.

<sup>78</sup> See paragraph 10.i of AS No. 7.

<sup>79</sup> See paragraph 85 of SQCS No. 7.

<sup>80</sup> See paragraphs 86 and 87 of SQCS No. 7.

<sup>81</sup> See paragraphs 88 and 89 of SQCS No. 7.

<sup>82</sup> See paragraph 37 of ISQC 1; paragraph 20 of ISA 220.

<sup>83</sup> See paragraphs 38(a) and 38(b) of ISQC 1; paragraphs 21(a) and 21(b) of ISA 220.

<sup>84</sup> See paragraph 11 of AS No. 7.

<sup>85</sup> See paragraph 88 of SQCS No. 7.

<sup>86</sup> See paragraph 38(c) of ISQC 1; paragraph 21(c) of ISA 220.

<sup>87</sup> See Section 103(a)(2)(A)(ii) of the Act.

<sup>88</sup> According to paragraph 12 of AS No. 7, "A significant engagement deficiency in an audit exists when (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client."

<sup>89</sup> See paragraph 13 of AS No. 7.

explicit provision for addressing differences of opinion. Firms may develop their own procedures for resolving such differences. Ultimately, however, under the standard, the reviewer may not provide concurring approval of issuance if there remains a significant engagement deficiency. If no concurring approval is provided, AS No. 7 requires that the EQR documentation include information that identifies the reasons for not providing the approval.

#### ASB

SQCS No. 7 does not include a requirement for the engagement quality reviewer to provide concurring approval of issuance. Instead, SQCS No. 7 requires the EQR be completed before the engagement report is released.<sup>90</sup> According to SQCS No. 7, when the engagement quality reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the firm's procedures for dealing with differences of opinion apply.<sup>91</sup> The firm's policies and procedures should require that conclusions reached be documented and implemented, and the engagement report not be released until the matter, on which the difference of opinion has arisen, is resolved.<sup>92</sup>

#### IAASB

The standards of the IAASB do not include a requirement for the engagement quality reviewer to provide concurring approval of issuance. Instead, the IAASB standards require that the engagement partner should not date the auditor's report until the completion of the EQR.<sup>93</sup> If differences of opinion arise between the engagement partner and the engagement quality reviewer, ISA 220 requires the engagement team to follow the firm's policies and procedures for dealing with and resolving differences of opinion.<sup>94</sup> ISQC 1 requires the firm to establish policies and procedures for dealing with and resolving differences of opinion between the engagement partner and the engagement quality reviewer. Such policies and procedures shall require that conclusions reached be documented and implemented, and the report not be dated until the matter is resolved.<sup>95</sup>

<sup>90</sup> See paragraph 81 of SQCS No. 7.

<sup>91</sup> See paragraph 91 of SQCS No. 7.

<sup>92</sup> See paragraph 78 of SQCS No. 7.

<sup>93</sup> See paragraph 36 of ISQC 1; paragraph 19(c) of ISA 220.

<sup>94</sup> See paragraph 22 of ISA 220.

<sup>95</sup> See paragraphs 43–44 of ISQC 1.

### Documentation of an EQR

#### PCAOB

Because of deficiencies in the documentation of concurring reviews, the Board decided to strengthen the existing documentation requirements. AS No. 7 requires that documentation of an EQR should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of the standard, including information that identifies: The engagement quality reviewer, and others who assisted the reviewer; the documents reviewed by the engagement quality reviewer and others who assisted the reviewer; and the date the engagement quality reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval.<sup>96</sup>

Unlike the standards of the ASB or the IAASB, AS No. 7 requires that the documentation of an EQR be included in the engagement documentation and provides requirements related to retention of and subsequent changes to the EQR documentation.<sup>97</sup>

#### ASB

According to SQCS No. 7, the documentation of an EQR should state that the procedures required by the firm's policies on EQR have been performed, the EQR has been completed before the report is released, and the reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.<sup>98</sup>

SQCS No. 7 requires that the firm should: Establish procedures designed to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation; and establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm, professional standards, laws, and regulations.<sup>99</sup>

#### IAASB

The engagement quality reviewer is required to document that the procedures required by the firm's

<sup>96</sup> See paragraph 19 of AS No. 7.

<sup>97</sup> See paragraphs 20–21 of AS No. 7.

<sup>98</sup> See paragraph 99 of SQCS No. 7.

<sup>99</sup> See paragraphs 63–71 of SQCS No. 7.

policies on the EQR have been performed, the EQR has been completed on or before the date of the auditor's report, and the reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.<sup>100</sup>

ISQC 1 requires that the firm should establish policies and procedures related to the completion of the assembly of final engagement files; confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation; and retention of engagement documentation.<sup>101</sup>

### III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Within 75 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents, the Commission will:

- (a) by order approve such proposed rules; or
- (b) institute proceedings to determine whether the proposed rules should be disapproved.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule is consistent with the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/pcaob.shtml>); or
- Send an e-mail to: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number PCAOB–2009–02 on the subject line.

#### Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number PCAOB–2009–02. This file number should be included on the

<sup>100</sup> See paragraph 42 of ISQC 1; paragraph 25 of ISA 220.

<sup>101</sup> See paragraphs 45–47 of ISQC 1.

subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/pcaob/shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. PCAOB-2009-02 and should be submitted on or before November 27, 2009.

By the Commission.

**Elizabeth M. Murphy,**  
*Secretary.*

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BILLING CODE 8011-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-60902; File No. SR-ISE-2009-83]

### Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Clarify the Definition of "Narrow-Based Index"

October 29, 2009.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 19, 2009, the International Securities Exchange, LLC (the "Exchange" or the "ISE") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which items have been prepared by the Exchange. The Exchange has filed the proposal as

a "non-controversial" proposed rule change pursuant to Section 19(b)(3)(A)(iii) of the Act<sup>3</sup> and Rule 19b-4(f)(6) thereunder.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to amend ISE Rule 2001(i) by clarifying the definition of "industry index" and "narrow-based index" to include indices having component securities that are all headquartered within a single country. The text of the proposed rule change is available on the Exchange's Web site <http://www.ise.com>, at the principal office of the Exchange, and at the Commission's Public Reference Room.

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections A, B and C below, of the most significant aspects of such statements.

##### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

This proposed rule change is based on a filing previously submitted by NASDAQ OMX PHLX, Inc ("PHLX") that was effective on filing.<sup>5</sup>

ISE proposes to amend Rule 2001, which defines the terms "industry index" and "narrow-based index" to mean "an index designed to be representative of a particular industry or a group of related industries," to also accommodate an index having component securities that are all headquartered within a single country to be listed as a narrow-based index pursuant to Exchange rules. This would enable options based on an index, including companies all headquartered within a single country, to be rightfully

considered as a generic narrow-based index for purposes of listing on the Exchange and trading.

The listing and trading of index options on the Exchange is generally conditioned on the ability to meet the rule requirements for narrow-based and broad-based indexes.<sup>6</sup> More particularly regarding narrow-based indexes, Rule 2002(b) states that the Exchange may trade options on an underlying index pursuant to Rule 19b-4(e) of the Act<sup>7</sup> where all of the noted conditions noted are satisfied.<sup>8</sup> Indeed, the Exchange has, and continues to, list and trade options on narrow-based indexes based on industries or a group of related industries that are located within various countries. These options are traded pursuant to the Exchange's index option trading rules.<sup>9</sup>

With the Exchange's interpretation of Rule 2001(i) as discussed herein, the Exchange proposes to list and trade options, pursuant to Rule 2002(b), on an index(es) that has component securities, which are all headquartered within a single country. The Exchange represents that, in all other material aspects, options on the underlying narrow-based index would be required to satisfy all other requirements for generic listing and trading pursuant to Rule 2002(b) and options on such indexes would be traded pursuant to the Exchange's trading rules.<sup>10</sup> The proposed rule

<sup>6</sup> A "broad-based index" or "market index" is defined in ISE Rule 2001(j) as an index designed to be representative of a stock market as a whole or of a range of companies in unrelated industries.

<sup>7</sup> The Chicago Board Options Exchange and PHLX have the same ability pursuant to their own rules.

<sup>8</sup> These include the index is capitalization-weighted, price-weighted, modified capitalization-weighted or equal dollar-weighted, and consists of ten or more component securities; each component security has a market capitalization of at least \$75 million, except that for each of the lowest weighted component securities in the index that in the aggregate account for no more than 10% of the weight of the index; the market capitalization is at least \$50 million; and trading volume of each component security has been at least one million shares for each of the last six months, except that for each of the lowest weighted component securities in the index that in the aggregate account for no more than 10% of the weight of the index, trading volume has been at least 500,000 shares for each of the last six months. See Rule 2002(b)(1)-(12) for all of the conditions [sic].

<sup>9</sup> See Chapter 20 (index options trading rules). See also Chapters 1 through 19 (general options trading rules).

<sup>10</sup> See *id.* The trading rules include, among other things, position limits, exercise limits and terms of options contracts (Rules 2005, 2007 and 2009). See also Securities Exchange Act Release No. 48405 (August 25, 2003), 68 FR 52257 (September 2, 2003) (Order Approving Proposed Rule Change and Amendment No. 1 by the International Securities Exchange, Inc. Relating to the Establishment of Trading Rules for Index Options and Generic Listing and Maintenance Standards for Narrow-Based Index Options).

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>4</sup> 17 CFR 240.19b-4(f)(6).

<sup>5</sup> See Exchange Act Release No. 60150 (June 19, 2009), 74 FR 30658 (June 26, 2009) (SR-Phlx-2009-35).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.