

November 3, 2010

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

***Re: Application of the “Failure to Supervise” Provision of the Sarbanes-Oxley Act of 2002 and Solicitation of Comment on Rulemaking Concepts (PCAOB Release No. 2010-005, August 5, 2010, Rulemaking Docket Matter No. 31)***

Deloitte & Touche LLP appreciates the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (the “PCAOB” or the “Board”) on its release *Application of the “Failure to Supervise” Provision of the Sarbanes-Oxley Act of 2002 and Solicitation of Comment on Rulemaking Concepts* (PCAOB Release No. 2010-005, August 5, 2010, Rulemaking Docket Matter No. 31) (the “Release”).

The Release seeks comments on the concept of requiring registered firms to make and document clear assignments of responsibility for implementation of quality control functions, and on whether such rulemaking should be formulated using general terms or more detailed terms. Although current professional standards contain requirements with respect to supervision, improvements in the clarity of the standards in this area would likely lead to improved accountability and improved audit performance. We believe any efforts to develop further standards with respect to making and documenting assignments of responsibility should be encompassed in revisions to the PCAOB’s quality control standards. We recognize that the PCAOB has on its current agenda a project to update its quality control standards and that the PCAOB’s Standing Advisory Group recently discussed this topic at its October 2010 meeting. We are supportive of such a project to revise the quality control standards, and we have several related recommendations and observations which are explained in the attached comments on Part II of the Release.

The Board has also included in Part I of the Release an interpretation of Section 105(c)(6) of the Sarbanes-Oxley Act of 2002, as to which the Board states that it is not seeking comment. Because Part I of the Release is inextricably linked to Part II and addresses matters of significance, we believe it also will be helpful to the Board, and necessary to any standard setting process, to comment on this section of the Release as well. Although the Board states that Part I of the Release “reminds registered firms and associated persons of, and highlights the scope of, section 105(c)(6),” we believe that several aspects of the discussion in Part I of the Release go

beyond what Congress intended under Section 105(c)(6). For example, we are concerned that the Board seeks to expand failure to supervise liability through an unduly broad interpretation of the statute's "or otherwise" clause; we believe that in considering any potential liability under Section 105(c)(6), it is critical for the Board to require a strong nexus between a purported breach of supervisory responsibility and an associated person and his or her predicate violation. At the same time, we recognize that individual professionals within accounting and auditing firms, including those responsible for quality control functions, may be accountable under other laws and standards (e.g., for a failure to exercise due professional care) when they have not complied with professional standards and the "failure to supervise" statute is not applicable. Our comments on Part I of the Release are also included in the attached.

We would welcome an opportunity to discuss these matters with the Board and the Staff. Dialogue with commenters will facilitate a more complete understanding of the comments, fuller consideration of related implications, and, we believe, will ultimately improve the standards the PCAOB develops and the auditor's ability to implement them effectively and efficiently. If you have any questions or would like to discuss these matters further, please do not hesitate to contact Robert Kueppers at (212) 492-4241, William Platt at (203) 761-3755, or John Fogarty at (203) 761-3227. We thank you for your consideration of these matters.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: Daniel L. Goelzer, Acting PCAOB Chairman  
Bill Gradison, PCAOB Member  
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## Comments on Part II of the Release

Our comments below are provided in response to questions posed by the PCAOB in its Release. Questions from the Release are provided in italics followed by our responses.

1. *The principal objectives of the type of rulemaking described above would be clarity within firms about accountability for supervisory responsibilities and the creation of documentation identifying lines of accountability.*
  - a. *Is it appropriate to pursue the objectives through rulemaking, or are there reasons to pursue those objectives through other means?*

The PCAOB is considering the development of requirements for registered firms “to make and document clear assignments” of certain supervision responsibilities (or what is sometimes described in the Release as responsibilities for implementation of quality control functions). One result of the PCAOB’s efforts in this regard might be to obtain clarification of the accountability for supervision responsibilities in addition to the responsibilities of the practitioner in charge of an audit engagement (e.g., by requiring documentation of responsibilities of those who may be “supervising” the engagement partner), as the responsibilities of the engagement partner are already set out in some detail in existing standards. We agree that clarity should exist with respect to accountability for implementation of quality control functions.

In considering changes to the quality control standards, it is important to evaluate the requirements and guidance that currently exist. Current professional standards with respect to supervision are focused on two areas: (1) supervisory responsibilities with respect to audit engagement teams by the practitioner in charge of the engagement (*i.e.*, the engagement partner), and (2) the quality control system of the firm.

In the first area, the current professional standards provide specific responsibilities and obligations with respect to the supervision of an engagement team by the engagement partner; these standards also have been supplemented by the PCAOB’s recently revised risk assessment standards. The PCAOB’s recently approved standard, *Supervision of the Audit Engagement*, explains that the engagement partner is responsible for proper supervision of the work of engagement team members and describes the nature and extent of supervisory activities necessary for proper supervision of engagement team members. According to this new standard, the supervisory activities the partner performs include:

- Informing engagement team members of their responsibilities;
- Directing engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities so they can evaluate those issues and determine that appropriate actions are taken in accordance with PCAOB standards;
- Reviewing the work of engagement team members to evaluate whether:
  - The work was performed and documented;

- The objectives of the procedures were achieved; and
- The results of the work support the conclusions reached.

See Auditing Standard No. 10, *Supervision of the Audit Engagement* (adopted Aug. 5, 2010) (SEC approval pending).

In the second area, current standards provide specific requirements with respect to the system of quality control within a firm.

Fundamentally, we agree that the clear assignment and documentation of quality control-related responsibilities has the potential to improve compliance with audit standards and enhance audit quality. To do so, we believe that these objectives should be accomplished through revisions to the quality control standards, rather than through separate rulemaking. The current quality control standards focus on: (1) independence, integrity, and objectivity; (2) personnel management; (3) acceptance and continuance of clients and engagements; (4) engagement performance; and (5) monitoring. Because ‘personnel management’ is the area of the quality control standards that most closely relates to aspects of audit engagement supervision, this area provides a foundation for the development of further requirements for the assignment and documentation of such responsibilities to maintain audit quality.

By way of example only, we believe the PCAOB could consider enhancing the quality control standards to require firms to describe and document the process and responsibility for assigning partners to audit engagements. For each engagement, there could be a person who is accountable for assigning the partner to a particular engagement and a person who is accountable for determining the continued suitability of that partner assignment.

Any potential requirements relating to the making and documentation of assignments, however, should be flexible and functional. As discussed below, any requirements should be conducive to implementation by firms of different sizes and structures and should not be unduly prescriptive. In addition, as discussed below in response to Question 2 and in our comments on Part I, any future standard setting related to such requirements should make clear that individuals who are performing oversight functions in connection with quality control standards will constitute a group broader than those who, and will not necessarily themselves, perform “supervisory responsibilities” for purposes of Section 105(c)(6).

2. *To the extent these objectives are pursued through Board rulemaking, are there potential unintended consequences to take care to avoid, i.e., ways in which pursuing the objectives might inadvertently diminish accountability or audit quality?*

The PCAOB should create quality control standards using general terms; such standards should set forth the principal objectives to be met and provide flexibility for the firms to determine how best to meet those objectives based on the size and structure of the firm. Because of the wide disparity in the size and other applicable characteristics of the firms registered with the Board, it would simply be unworkable to require a specific approach for all firms. Firms need to have the flexibility to adhere to the quality control standards in a manner that best suits their organizations. This axiom is reflected in the quality control standards themselves. For example,

the current standards require firms to assign responsibility to an individual or individuals for the design and maintenance of quality control policies and procedures; they do not specify the position or title of the person or persons (e.g., Chief Quality Officer) who will have such responsibilities. Overly prescriptive, detailed requirements would stifle the creation by firms of effective ways to accomplish the objectives of the quality control standards. Therefore, we encourage the PCAOB to avoid developing prescriptive standards that require specific approaches or structures for assigning responsibilities for the implementation of quality control functions.

Any requirements that the Board might impose for the making and documenting of assignments of responsibilities relating to quality control functions cannot themselves be the basis for imposing Section 105(c)(6) failure to supervise liability. The responsibilities included in such documentation may or may not be supervisory in nature, and, where they are, the requisite nexus to an audit and predicate violation may not be present. For example, there is an important difference between audit supervision (*i.e.*, direct contact and oversight of the work of the audit engagement team) and performing functions that are intrinsic to the management of an audit firm (e.g., responsibilities related to running the firm from an operational perspective). Even if such management functions involve some supervisory responsibilities with respect to the quality control system that are assigned and documented, individuals holding those positions will in most instances not have supervisory responsibilities for purposes of Section 105(c)(6). Any assignment and documentation of responsibilities should not be subject in this regard to misinterpretation in either an enforcement or litigation context. This concern is more fully discussed in the *Comments on Part I of the Release*, below.

Further, if the Board moves forward with standard setting in this area, potential unintended consequences should be evaluated in determining what is considered to be “supervision.” For example, potential unintended consequences could result from creating a “supervisor” above the audit engagement partner. If the PCAOB requires that the firms have a supervisor overseeing the performance of an engagement partner’s audits, it is possible that the engagement partner will believe he or she has less responsibility with respect to the quality and supervision of the audit. Additionally, unintended consequences could result from designating consultation resources as supervisory. Creating a supervisory responsibility for those who are consulted would potentially diminish the responsibility of the engagement partner, potentially impact the day-to-day supervision of the audit engagement, and possibly result in a reluctance to participate in consultations. We believe such unintended consequences would be detrimental to the quality of audits.

3. *Are there related or different rulemaking objectives that would complement application of section 105(c)(6) that should be pursued instead of, or in addition to, the objectives described here?*

As discussed above, we believe that any efforts related to clarifying or adding to supervisory responsibilities should be accomplished through revision to the PCAOB’s quality control standards. In doing so, the PCAOB needs to consider changes it has recently made through its new standard, *Supervision of the Audit Engagement*.

In addition to the above, we also recommend that the PCAOB update its interim quality control standards to adopt language from the International Standard on Quality Control No. 1 and the AICPA's Statement on Quality Control Standards No. 7.

### *Comments on Part I of the Release*

In seeking to clarify supervisory responsibilities, the Release provides in Part I its general interpretation of liability under Section 105(c)(6). We offer these comments in response to Part I of the Release because the Board inextricably links its discussion in Part I of the scope of Section 105(c)(6) to its discussion in Part II of possible rulemaking on the making and documenting of assignments of what it sometimes refers to as supervision responsibilities. We believe the Board's interpretation of the scope of its authority is incorrect and could result in the misuse of the assignments and their documentation.

The following considerations should inform any interpretation of Section 105(c)(6). *First*, liability under Section 105(c)(6) should be tied to a departure from actual rules or standards. *Second*, Section 105(c)(6) requires a strong nexus between the exercise of supervisory responsibility and the underlying predicate violation and the associated person responsible for the violation. *Third*, the "safe harbor provision" of Section 105(c)(6)(B) should be applied as a rule of construction, meaning it should be considered an element for establishing failure to supervise liability, not an affirmative defense.

#### *1. Liability for a Failure to Supervise Under Section 105(c)(6).*

According to the Release, "the range of conduct that the Board might address through the 'or otherwise' clause *encompasses conduct not covered by any supervision rules or standards.*" Release, at 4 (emphasis added). To the extent this is so, the "or otherwise" phrase cannot be read so as to decouple a failure to supervise from *any* rule or standard.

It is unlikely that Congress sought to extend liability through the use of the ancillary phrase "or otherwise" to circumstances where the challenged conduct does not involve a departure from rules and standards applicable to the profession. See *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 468 (2001) (Congress does not "hide elephants in mouseholes," in other words, Congress "does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions"). Rather, the Board should interpret Section 105(c)(6) to be invoked only by a departure from the Board's supervision rules or standards, or from the Board's other rules and standards or applicable professional standards. Such a reading makes grammatical sense; gives appropriate weight to the ancillary clause "or otherwise"; and maintains the basic structure of the regulatory scheme established by Congress.

#### *2. Who Is a Supervisor; A Requisite Strong, Defined Nexus.*

The Release is not clear about what the Board would consider to be supervision. The word "supervision" stems from Latin, roughly meaning "to have sight over," or "oversight." Webster's Third New International Dictionary provides a fitting definition of "to supervise" -- to "coordinate, direct, and inspect continuously and *at first hand* the accomplishment" of an

objective.<sup>1</sup> A leading legal dictionary echoes this interpretation, defining “supervision” as “[t]he act of managing, directing, or overseeing persons or projects.”<sup>2</sup> The Oxford English Dictionary defines supervision as follows: to “[o]bserve and direct the execution of a task or activity of work of a person.”<sup>3</sup> These definitions capture the common and practical application of the term “supervision,” and best reflect how Congress likely intended to limit the application of Section 105(c)(6).

In addition, as the Release appears to accept, Section 105(c)(6) requires a strong nexus between the supervisory person, and the predicate violation and the person responsible for it. The Release notes that, for liability under Section 105(c)(6) to exist, there must be a “sufficient connection . . . between unreasonable supervisory conduct and a particular predicate violation.” Release, at 9. Such a nexus will promote the Board’s advocacy of transparency and clarity as to failure to supervise requirements.

The statutory text clearly imposes a strong nexus requirement. Significantly, Section 105(c)(6) imposes failure to supervise liability “*with a view to preventing violations*” of the statute, related rules, and professional standards. See 15 U.S.C. § 7215(c)(6)(A) (emphasis added). The text thus makes clear that a supervisor should not be held liable for just any conduct of a subordinate—the purpose of the provision is to prevent violations of applicable rules and standards.

In light of these definitions and the nexus element, we believe that the individuals who are subject to failure to supervise liability ordinarily should not extend beyond engagement team personnel, but could include others (e.g., because of the circumstances of the particular engagement, someone who was in a position to have exercised extensive and continuous oversight over the audit; someone who assigned the engagement partner to the audit or evaluated the engagement partner). In any event, the application of Section 105(c)(6) will require a close examination of the facts and circumstances of the purported departure from supervisory responsibilities, and at least a demonstrable nexus between the “supervisor” and the associated person and the predicate violation of standards or law for which the associated person was responsible.

All other individuals in the firm hierarchy without the requisite nexus to the audit engagement would be outside scope of failure to supervise liability. This would include those, whether or not in a national office, performing management functions or even having responsibilities within the quality control system of the firm. That is not to say that, like many professionals in an accounting and auditing firm, they would not have an obligation to meet professional standards; they would. And, as a result of such obligation, they could be subject to avenues of enforcement other than for a “failure to supervise” (e.g., for a failure to exercise due professional care). We recognize the important function that quality control personnel serve by helping to ensure audit quality, and such personnel may in certain circumstances be held accountable for carrying out this function through the Board’s existing rules and standards. These individuals, however, should generally not be subject to Section 105(c)(6) liability.

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<sup>1</sup> WEBSTER’S THIRD NEW INT’L DICTIONARY (3d ed. 1978) (emphasis added).

<sup>2</sup> BLACK’S LAW DICTIONARY 1576 (9th ed. 2009).

<sup>3</sup> CONCISE OXFORD ENGLISH DICTIONARY (11th ed. 2008).

If the PCAOB moves forward in requiring firms to document supervision responsibilities, it needs to distinguish the significantly broader group of positions and individuals whose responsibilities may be covered in such documentation from the limited group who might be considered “supervisors” for purposes of Section 105(c)(6).

3. *The Safe Harbor Provision as an Integral Rule of Construction for Section 105(c)(6).*

We believe that the Release is incorrect in characterizing the statutory safe harbor provision as an “affirmative defense” (Release, at 9). Instead, the statute makes clear that the safe harbor provision is a rule of construction and should be considered an element of establishing a failure to supervise violation. The Board must satisfy itself that the conditions of the safe harbor provision are not met when it seeks to apply the statute; the burden should not be shifted to the potential subject of liability to prove an affirmative defense.

The text of the statute provides that “[n]o associated person of a registered public accounting firm *shall be deemed* to have failed reasonably to supervise any other person for purposes of subparagraph (A),” if the two conditions of the safe harbor provision are satisfied (essentially, that the firm had a compliance system in place and that the person reasonably discharged his duties under that system). Section 105(c)(6)(B) (emphasis added). Therefore, under the text of the statute, the Board “shall not deem” any person to have violated Section 105(c)(6) unless the Board is satisfied that the two conditions are not met.

As noted above, the Release relies only on a fragment of legislative history to characterize the safe harbor as an affirmative defense. *See* Release, at 9. The Senate Report describes the safe harbor provision as “permit[ting] an accounting firm to defend itself from supervisory liability by showing that its internal control procedures were reasonable and were operating fully in the situation at issue.” *Id.* (quoting Senate Report, at 11). Although the Senate Report uses the terms “by showing,” such attenuated legislative history cannot override the text of the statute. Congress did not label this provision an “affirmative defense,” which it is capable of doing, and made the choice to enact it as a rule of construction. Pursuant to the plain text of the statute and Congress’ intent, a coherent interpretation of Section 105(c)(6) must apply the safe harbor provision as a rule of construction, such that it is a necessary element for seeking to impose failure to supervise liability.