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James C. Schulwolf
jschulwolf@goodwin.com

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Nicole F. Munro
nmunro@hudco.com

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mac_mccoy@flmd.uscourts.gov

SECRETARY

Norman M. Powell
npowell@ycst.com

BUDGET OFFICER

Thomas J. Walsh
twalsh@brodywillk.com

CONTENT OFFICER

Lisa R. Lifshitz
llifshitz@torkinmanes.com

DIVERSITY OFFICER

Sylvia Fung Chin
schin@whitecase.com

MEMBERSHIP OFFICERS

Michael F. Fleming
michael_fleming@uhc.com
Jonathan Rubens
rubens@mosconelaw.com

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pchristophorou@cgsh.com

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Susan Daly Tobias
susan.tobias@americanbar.org



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Business Law Section

321 N. Clark Street
Chicago, IL 60654-7598

T: 312-988-5588 | F: 312-988-5578

businesslaw@americanbar.org

ababusinesslaw.org

Via Electronic Submission

March 6, 2023

Ms. Phoebe Brown
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

**Re: PCAOB Rulemaking Docket Matter No. 046
A Firm's System of Quality Control and Other
Proposed Amendments to PCAOB Standards, Rules
and Forms**

Dear Ms. Brown,

This letter is submitted on behalf of the Law and Accounting Committee (the "Committee" or "we") of the Business Law Section of the American Bar Association (the "ABA"), on the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") Release No. 2022-006, *A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms* (the "Proposed Standard" or the "Release"). We appreciate the opportunity to comment on the Proposed Standard.

The views expressed herein have not been approved by the House of Delegates or Board of Governors of the American Bar Association and should not be construed as representing policy of the Association. In addition, this letter does not represent the official position of the ABA Business Law Section, nor does it necessarily reflect the views of all members of the Committee, the drafting committee or their respective firms or clients.

We support the PCAOB's efforts to modernize and enhance its standards in regards to audit quality, and we recognize the importance of the Proposed Standard for the accounting profession and capital markets. We also appreciate the Board's careful consideration of recently adopted quality control (QC) standards, including the International Standard on Quality Management 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services*

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Chicago, IL 60654-7598

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businesslaw@americanbar.org

ababusinesslaw.org

Engagements (ISQM 1), adopted by the International Auditing and Assurance Standards Board (IAASB), and the Statement on Quality Management Standards No. 1, *A Firm's System of Quality Management* (SQMS 1), adopted by the American Institute of Certified Public Accountants (collectively referred to as the "Other QC Standards").

At the same time, we observe that there could be certain legal consequences presented, including to members of the accounting profession, as a result of the Proposed Standards that may merit further analysis and consideration. In this letter, we address three specific observations and offer suggestions that the PCAOB may wish to consider before adopting any final standard.

1. The Proposed Standard should clarify the standard for liability for the individual certifying to the effectiveness of the QC system.

Proposed QC 1000.14.d and 1000.15.b provide that the individual responsible for oversight of a firm's quality control system ("QC system") as a whole and the individual with operational responsibility for the QC system as a whole (the "QC Manager") must certify to the statements in a registered firm's annual quality control report on Form QC.

The proposed text of the certification, reflected in Form QC item 3.2, appears to be modeled after the certifications used by an issuer's chief executive officer and chief financial officer to certify the issuer's financial statements pursuant to Section 302 of the Sarbanes-Oxley Act.¹ Courts have held that a Section 302 certifier can be held personally liable for an inaccurate statement in a certification only if he or she made the statement knowing it was false or recklessly not knowing it was false; mere negligence has not been held to be sufficient.²

In adopting any final QC standard, we encourage the Board to clarify that these same state-of-mind requirements will apply in considering

¹ See 17 C.F.R. § 240.13a-14.

² See *SEC v. Jensen*, 835 F.3d 1100 (9th Cir. 2016) ("by definition, one cannot certify a fact about which one is ignorant or which one knows is false"); *id.* at 1118 (Bea, J., concurring) (finding that liability should only attach in cases of knowledge or recklessness); *SEC v. Miller*, 2:17-cv-897-CBM, 2019 WL 1460615, at *2 (C.D. Cal. Feb. 6, 2019) ("knowledge or recklessness is a required element" of Rule 13a-14 claim); *SEC v. E-Smart Techs., Inc.*, 82 F. Supp. 3d 97, 114-15 (D.D.C. Feb. 12, 2015) (analyzing SEC claims against CEO for inaccurate certification under test of whether she knew statements were false).

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compliance with the QC 1000 certification requirements in order to align with the standards applied to the Section 302 certification, after which the QC 1000 certifications are modeled. This clarification also would be consistent with the intention of Congress. During the debate regarding Sarbanes-Oxley, legislators were clear that the potential liability of senior executives for good-faith errors in certification was a matter of deep concern for them.³ Similarly here, to avoid the imposition of a standard that risks making it more challenging for registered public accounting firms to retain talent in senior positions, we urge the Board to clarify the state-of-mind requirements as set forth above.

Additionally, while we believe the text of the certification suggests that a certifying individual should be considered to have violated QC 1000 only to the extent that the inaccuracy in a submitted certification is material to an investor's or reasonable auditor's understanding of the QC system as a whole, we propose that the Board also confirm that is the case.

2. The Board should consider additional liability protections for individuals providing certifications regarding the evaluation of firms' QC systems.

The Proposed Standard's requirement to have a designated person with responsibility for designing and overseeing the QC system is an important and effective approach to assuring quality control. As noted above, the Proposed Standard includes a requirement for the individual responsible for oversight of a firm's QC system as a whole and the QC Manager (collectively, the "QC Certifiers") to certify certain aspects of the QC system. The Board's desire to bolster confidence in the QC system with such a certification is understandable. However, aside from the desire for greater clarity around the applicable liability standard, we are concerned about the potential for unnecessary and excessive liability that the certification could impose upon the QC Certifiers, and the effect of such liability upon registered firms' ability to recruit qualified professionals to serve, particularly as the QC Manager.

³ See, e.g., Congressional Record at S6553 (July 10, 2002) (Sen. Gramm introducing Wall Street Journal editorial stating, in part, that the Department of Justice's corporate fraud task force should "keep in mind the requirement of mens rea, or criminal intent, when it's CEO hunting . . . If otherwise honest CEOs can be indicted merely for putting their names to a statement that turns out to be false, good luck finding competent executives.").

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jschulwolf@goodwin.com

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Nicole F. Munro
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Mac Richard McCoy
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The QC system for a large firm necessarily encompasses many components, and it affects and is affected by all the professionals in the firm. Given the expansive scope of a firm's QC system, it would be unrealistic to expect that a QC Certifier would be able to provide absolute assurance that the QC system would always operate perfectly and that there would be no failures. The QC system is populated and operated by many individuals, and although all parties have an interest in minimizing failures, some failures are likely to occur. Importantly, the Release, as well as the proposed QC 1000 standard itself, describes the QC system in terms of reasonable assurance, which is helpful to the objective of keeping the QC Certifiers' liability at a fair level. However, we believe consideration should be given in any final adopting release as to whether to go further and expressly state that while the QC Certifiers are responsible for exercising professional competence in connection with the design and operation (and may face consequences for failure to do so) of the firm's QC system, the QC Certifiers shall not be held responsible for inevitable system errors or the wrongful acts of others which may, in limited circumstances, overcome the best of those efforts.

We note that, perhaps out of similar concerns, the IAASB chose not to include a certification requirement in the recently adopted ISQM 1.⁴ Several commenters have opined that the firm certification is sufficient to achieve the goal of the auditing standards.⁵

We are particularly concerned in this context with the final clause in the proposed certification,⁶ which states that the firm has disclosed all unremediated quality control deficiencies. Although the certification has a knowledge qualifier, and the suggestions noted in Section 1 above may mitigate some risk, we remain concerned that this certification could lead to

⁴ International Standard on Quality Management 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements (Dec. 2020), available at <https://www.ifac.org/system/files/publications/files/IAASB-Quality-Management-ISQM-1-Quality-Management-for-Firms.pdf>.

⁵ See, e.g., Comment Letter of RSM US LLP re PCAOB Rulemaking Docket Matter No. 046 at 15 (Mar. 20, 2020), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket046/009_rsm-us-llp.pdf?sfvrsn=762a2992_0.

⁶ "[The Firm's other certifying officer(s) and] I [are/am] responsible and accountable for [Firm]'s QC system as a whole and have: ... (c) Disclosed, based on such evaluation, all unremediated QC deficiencies (as defined in QC 1000) of which I am aware."

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jschulwolf@goodwin.com

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Mac Richard McCoy
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susan.tobias@americanbar.org



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Chicago, IL 60654-7598

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businesslaw@americanbar.org

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unnecessary disputes over what the QC Certifiers should have known in a particular circumstance.

Obtaining a certification from the firm (not the individual) may sufficiently address this item without discounting the standards to which auditors are held.

The proposed certification brings a potential threat of additional liability for those in the accounting profession and could affect the recruitment of talented individuals needed to fill critical roles within the firm, including the QC Manager position.⁷ This could cause concern among potential candidates about the balance between accountability and potentially significant liability.⁸ We submit the approach outlined above as a consideration in the direction of setting an appropriate balance in that regard.

3. Firm quality control reports should be privileged from disclosure pursuant to Section 105(b)(5)(A) of the Sarbanes-Oxley Act.

The Board proposes that registered public accounting firms be required to prepare and file an annual quality control report on Form QC.⁹ The report would describe the results of the firm's annual evaluation of the effectiveness of its QC system, including information regarding QC deficiencies identified in the evaluation. The Board proposes that the Board

⁷ In this regard, we note a 2016 speech from then-Enforcement Director Andrew Ceresney regarding his view of the state of auditor liability:

"We rely on auditors as essential partners in ensuring comprehensive, accurate, and reliable financial reporting, and they have our full support in this regard. That said, we will continue to scrutinize auditor work in all of our investigations. While good faith errors in judgment will not result in liability, those who fail to follow audit standards and perform unreasonable audits can expect scrutiny through our enforcement efforts."

Andrew Ceresney, Director, Division of Enforcement, Keynote Address: American Law Institute Conference on Accountants' Liability 2016: Confronting Enforcement and Litigation Risks, Washington, D.C., *The SEC Enforcement Division's Focus on Auditors and Auditing* (Sept. 22, 2016), available at <https://www.sec.gov/news/speech/ceresney-enforcement-focus-auditors-and-auditing> (emphasis added).

⁸ Drew Niehaus, *Fixing the Crisis in Accounting: Five Steps to Attracting Tomorrow's CPAs*, CPA Journal (Nov. 2022), <https://www.cpajournal.com/2022/11/25/fixing-the-crisis-in-accounting/> (citing heavy SEC scrutiny as a contributing factor in the shortage of skilled accountants).

⁹ Proposed QC 1000.79 – .80.

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will not make a Form QC or its contents public, except in an enforcement proceeding.¹⁰

We agree with the Board that Form QCs and their contents should be kept confidential. However, we recommend that the Board clarify the proposed rule to state expressly that Form QCs and their contents are privileged and confidential under Section 105(b)(5)(A) of the Sarbanes-Oxley Act. Therefore, these submissions to the Board will not be subject to discovery in any litigation forum or public disclosure pursuant to the Freedom of Information Act, or otherwise.

Section 105(b)(5)(A) provides in pertinent part, that "all documents and information . . . prepared or received by or specifically for the Board . . . in connection with an inspection under Section 104 . . . shall be confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery or other legal process) in any proceeding in any Federal or State court or administrative agency." The section also provides that such information in the hands of other agencies is exempt from disclosure under the Freedom of Information Act.¹¹ This important provision encourages full candor and cooperation by firms with Board inspections by ensuring that information provided by the firms will not be obtained and potentially used against them in third-party litigation or for other purposes.

By definition, Form QC would be "prepared . . . specifically for the Board." We also believe that the QC report would be provided "in connection with an inspection." Firm quality control is a key focus of the inspection process. In conducting an inspection, the Board is required to "evaluate the sufficiency of the quality control system of the firm, and the manner of the documentation and communication of that system by the firm."¹² The Board is also required to identify potential violations of a firm's quality control standards revealed in the inspection.¹³ A Form QC is likely to be an integral

¹⁰ Proposed Rule 2203A.

¹¹ 15 U.S.C. § 7215(b)(5)(A). Section 105(b)(5)(B) and (C) permits disclosure to certain federal, or foreign agencies, without waiving the protections of Section 105(b)(5)(A). Section 105(b)(1)(A) also permits disclosure in connection with a public proceeding or if released in accordance with Section 105(c).

¹² Sarbanes-Oxley Act, § 104(d)(2), 15 U.S.C. § 7214(d)(2). The Board is also directed to "perform such other testing of the . . . quality control procedures of the firm as are necessary or appropriate in light of the purpose of the inspection and the responsibilities of the Board." *Id.* at § 104(d)(3), 15 U.S.C. § 7214(d)(3).

¹³ Sarbanes-Oxley Act, § 104(c)(1), 15 U.S.C. § 7214(c)(1).

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part of this process. To the extent that the report identifies deficiencies, those deficiencies will likely be the subject of an inspection or even an investigation (which is also subject to Section 105(b)(1)(A)). Indeed, as the Board notes, some of the deficiencies discussed in the QC report may themselves have resulted from Board inspection findings.¹⁴

The Board refers to Section 105(b)(5)(A) and suggests that “[d]epending on how a QC deficiency has come to light, certain information contained within a Form QC might be confidential pursuant to Section 105(b)(5)(A).”¹⁵ We respectfully suggest that this formulation is unduly narrow and creates uncertainty for firms as to what information it provides will or will not be subject to discovery or public disclosure by other agencies. It is also not clear how determinations would be made as to which information in a Form QC is subject to the Section 105(b)(5)(A) and which is not. Such a piecemeal approach seems inconsistent with the Board’s own view that “making incomplete, potentially confusing and potentially misleading Form QCs public would [not] be in the interests of investors or other stakeholders.”¹⁶ It also seems inconsistent with the Board’s observation that “firms may be in a better position to report fully and candidly to the PCAOB about their annual evaluation—more effectively supporting both their own remediation efforts and our oversight activities—if they are confident that the information would be understood and used in the context of a broader understanding of their overall audit practice and an ongoing dialogue between the firm and the PCAOB.”¹⁷ In sum, we believe it will serve the Board’s purposes even more fully to make clear that all of Form QC and its contents benefit from the privilege established by Section 105(b)(5)(A).

* * *

¹⁴ PCAOB Release No. 2022-006, *A Firm’s System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms* at 212 (Nov. 18, 2022).

¹⁵ *Id.* at 213.

¹⁶ *Id.*

¹⁷ *Id.*

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Aurora Abella-Austriaco

SECTION DIRECTOR

Susan Daly Tobias
susan.tobias@americanbar.org



AMERICANBARASSOCIATION

Business Law Section

321 N. Clark Street
Chicago, IL 60654-7598

T: 312-988-5588 | F: 312-988-5578

businesslaw@americanbar.org

ababusinesslaw.org

We appreciate the opportunity to participate in this process and respectfully request that the Board consider our observations and suggestions. We are available to meet and discuss these comments or any questions that the Board and its staff may have, which may be directed to the individuals listed below.

Very truly yours,

Alan J. Wilson
Chair of the Law and Accounting
Committee

Drafting Committee:

Bob Dow
Michael Scanlon
Thomas W. White
Alan J. Wilson