



Members of the Investor Advisory Group

January 13, 2023

Via email

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

Reference: PCAOB No. 2022-06, Request for Public Comment – A Firm’s System Of Quality Control And Other Proposed Amendments To PCAOB Standards, Rules, And Forms

Dear Secretary Brown and Members of the Public Company Accounting Oversight Board (PCAOB):

The Investor Advisory Group appreciates the opportunity to comment upon the PCAOB’s proposed quality control standard (hereafter “the Proposal”).¹ We applaud the PCAOB for its process in developing the Proposal. In our comment letter on the PCAOB’s Strategic Plan (*PCAOB No. 2022-003, Request for Public Comment – PCAOB Draft Plan 2022-2026*), we recommended the replacement of interim auditing standards with modern ones of the PCAOB’s own design. The Quality Control standard proposal is a critical step in achieving this goal.

In formulating our response to the proposal, we judged it based on how well the proposal would meet investors’ needs, as provided by the auditor’s opinion on financial statements. A standard for a quality control management system for independent auditors should establish and include objectives for the system and discuss the benefit for investors. Investors need more than just a pass/fail grade on the audit as expressed in the auditor’s opinion. In addition to the basic audit opinion, they need:

- Information that allows them to decide if the audit was performed capably or not.
- Such information is necessary to allow investors to make rational decisions on whether to vote to approve or disapprove the ratification of the auditor or the election of the Chair or members of the audit committee.
- Most importantly, such information provides investors with a level of confidence in the financial statements of companies in which they invest. Their level of confidence in the financial statements has a bearing on the prices they will be willing to pay or demand for investments.

¹ This letter represents the views of Investor Advisory Group (IAG) and does not necessarily represent the views of all of its individual members, or the organizations by which they are employed. IAG views are developed by the members of the group independent of the views of the Public Company Accounting Oversight Board and its staff. For more information about the IAG, including a listing of the current member, their bios, and the IAG charter, see <https://pcaobus.org/about/advisory-groups/investor-advisory-group>.

Once established with rigor, the quality control systems of an auditing firm can help provide information about engagement-specific audit quality to investors if the information is quantified and communicated to investors. We see no evidence of this in the Proposal. Referring once again to our comment letter on the PCAOB's Strategic Plan, we recommended:

"...the development and establishment of audit quality indicators (AQI), at the audited company level, audit firm office level, and the audit firm level. AQIs would provide important feedback to auditing firms on how well they are managing their duties to their true clients: investors. It would provide the same information and feedback to investors so they can make more informed decisions about the continuation of auditors' services."

The process of establishing a quality control standard naturally fits simultaneously with the establishment of audit quality indicators. How else can consistent audit quality be maintained if it is not measured and quantified? The proposal fails to establish even a few audit quality indicators. We believe that the development of audit quality indicators should not be done in a vacuum, but as an adjunct project to the other auditing standards that the PCAOB is establishing. The replacement of the quality control standards is a logical place to start this approach.

Perhaps because there are no required quantified audit quality indicators, we see no new information in the Proposal that would be transmitted to investors. In fulfilling their duty to oversee audit committees and vote on the ratification of their appointment of auditors, investors should be provided with information about the quality of audits at the engagement level. We recognize that Section 104(g)(2) of the Sarbanes-Oxley Act constrains the Board from making public information on the proposed Form QC at even the firm level. There is no such constraint on providing audit quality indicator information, however, and we strongly encourage the Board to take its first steps in this direction by revising this proposal to include them.

Other information about the quality of audits and auditors is available to the Board but remains unavailable to investors in this proposal. An effective quality control system should provide investors with data regarding the quality of audits. We have already mentioned audit quality indicators as lacking in this proposal, but there is other insufficient data. Pursuant to the Sarbanes-Oxley Act, the PCAOB has the authority to conduct inspections of independent audits of publicly listed companies. As a result, the PCAOB has first-hand information about the quality of an audit it has inspected and the failures by the audit engagement team to perform the audit in accordance with the PCAOB's auditing standards. By withholding the names of companies whose audits have been inspected, the PCAOB is willingly withholding from investors knowledge of which specific audits complied with laws, regulations, and professional standards. SOX specifically requires the PCAOB to keep Part II of Inspection Reports confidential for up to, but no more than 12 months, and also requires enforcement actions to remain confidential until the end of the process. There is no such requirement for the disclosure of companies whose audits were selected for inspection, however. We recommend the PCAOB reverses its past policy of withholding this information from investors.

The proposal has been formulated without any apparent assessment of current practice. It seems to have been developed in a vacuum. Without an assessment of what is working or not working effectively in current practice, we believe the proposal may miss quality control attributes that need attention.

In addition, the 2008 report of the U.S. Treasury Advisory Committee on the auditing profession made a number of recommendations for improving audit quality as it relates to auditing firms. This current proposal on quality control systems does not incorporate their recommendations. Missing:

- As already mentioned, the proposal does not require the development of audit quality indicators.
- The proposal does not address the governance of a firm, including its structure and tone at the top.
- The proposal does not improve the transparency of the auditing firm reporting on the finances of the auditee. This can have an impact on the quality of an auditor's product provided to investors.

In addition, the proposal lacks sufficient focus on those processes necessary for the planning, design, implementation, monitoring, and reporting of the functioning of quality control systems. These processes commonly exist in other quality control system standards such as ISO 9000/9001. Such processes should develop actions necessary for prompt and timely identification and transparent reporting to the customer of deviations in the product from the planned and expected results. This must be done on a continuous basis, and not simply once every three years.

We are troubled by the Proposal's lack of specificity in the standard as it relates to the design of an audit firm's quality control system. We support the proposal's risk-based approach to designing a quality control system as a logical and reasonable means of designing systems for auditors of all sizes, but only up to a point. There is simply too much emphasis on scalability, and this dilutes the effectiveness of the proposed standard. Our concern is that when firms are given full authority to design their own quality control systems based on risk assessment and scalability, they will not be penalized for designing systems that will too easily be certified as working properly. We are also concerned that the proposed standard emphasis on a risk-based approach to the design of quality control systems will result in little or no change at the largest of auditing firms. We believe that this approach is already embedded in their quality control systems, and therefore the proposal would not result in improvements to their systems.

A process approach should permit a professional firm providing assurance to investors to plan, design implement its various processes and their interactions. It also requires the firm to adequately resource, manage and monitor its processes. This would include a process of continuous analysis of opportunities for improvement which are acted upon in a timely and effective manner. Risk-based thinking enables the firm, its leadership and employees, to determine the factors that could cause its processes and its quality management system to deviate from the planned results, to put in place preventive and monitoring controls to minimize the negative effects of deviations, and to make use of opportunities for improvements as and when they arise.

The goal of a quality control system should, and must be, zero defects in the product independent audit firms provide to investors. To accept a lower standard is contrary to the Sarbanes-Oxley Act of 2002. It also accepts a standard in which misleading audit reports would be considered acceptable at some level. The PCAOB should reject such an approach.

Establishing a quality management system should include both a process and risk analysis approach. Instead of prescribing a purely risk-based approach, we encourage the Board to develop a risk-based approach to quality control with minimum requirements integrated in it. To cite one area in particular, we believe the Board is capable of designing minimum standards for personnel qualifications and the supervision and training of audit staff and should require those minimum standards to be met.

We find the requirement to furnish audit committees with only a firm-wide evaluation of the quality control system to be insufficient. We question whether or not the audit committee would be inclined to seek a new auditor based only on a firm-wide evaluation of quality control – and one furnished to them by the auditor. The audit committee would be far more influenced by an independent verification of the quality system such as the PCAOB inspection report on their auditor, and its performance on their engagement, and including audit quality indicators.

In the engagement monitoring section, the proposal's implicit support of three-year inspections of engagement partners' work is flawed. The proposal notes that a three-year cycle for such inspections is common in practice and suggests that "[f]irms should consider incorporating a level of unpredictability in their selection of completed engagements, such that an engagement partner would not be certain which engagement would be selected or when an engagement would be selected." We recommend that the proposal go beyond suggesting that firms "should consider" adding unpredictability to the process and require that unpredictability be integrated into the partners' engagement review process.

We note one particularly important omission in the Proposal: it does not address incentives provided in partner compensation plans relative to quality control systems. Partner compensation is connected to revenues brought into the firm. As long as that incentive exists unchecked, quality control within a firm will remain secondary to revenue growth. We urge the Board to require that compensation plans provide at least as much weighting to the design and proper functioning of firm's quality control system as the compensation plans ascribe to revenue growth.

There is an inherent conflict of interest between auditors' pursuit of quality and pursuit of their own profit. The design of the quality control system should take this into account for the benefit of investors.

Our comments below address the different sections of the Proposal.

I. Proposed QC 1000: Basic Structure, Terminology, And Scalability

We believe that the proposed definitions contained within this section of the proposal are clear and appropriate.

We also believe that it is not appropriate to require firms that have not and do not plan to perform engagements pursuant to PCAOB standards to design QC system in accordance with QC 1000. It would be desirable for them to do so, on the grounds that they may someday attempt audits under the PCAOB standards, but until they actually prepare to undertake such duties, it would possibly impose costs on firms that may never fall under PCAOB jurisdiction.

As noted above, we are not in full support of the Proposal's emphasis on scalability for all firms based on their nature and circumstances. In fact, we favor less scalability and favor more prescriptive standards in this regard. Rather than leave the full design and determination of quality control systems up to all firms, we recommend the establishment of minimum qualifications for an effective QC system. The Proposal notes that there 70 sole proprietorships registered with the PCAOB (p. 49). Can these, and perhaps other small-sized registered firms, reasonably be expected to design an effective quality control system? We are not certain they can.

We recommend that the Board examine the attributes of its registrants and develop minimum requirements for the establishment of quality control systems. The most critical area to establish such minimum standards is in the area of education, training, and supervision of staff. We are confident that this task is within the scope of the PCAOB's authority and responsibility.

II. Proposed QC 1000: A Firm's System Of Quality Control

The Firm's QC System

The quality control system should have as an additional objective auditor's existing obligation to satisfy the needs of the key customer of audited financial reports—investors. We believe the benefits of explicitly identifying the key customer of audited financial reports in the objectives of the quality control system more than offsets any loss in clarity that the reasonable assurance objective may otherwise provide.

The lack of audit quality indicators is most evident in this section of the proposal. It is axiomatic that if an activity is not measured, it cannot be managed – and there are no measurement tools required by this section to assist in managing the system of quality control. We believe that the quality control standard's development should be integrated with the development of audit quality indicators. We urge the Board to consider developing and including a standardized tabular format that could be used to disclose the metrics that we suggest below. A standardized table is far easier for investors to consume and would enhance comparability over time and between firms. While we understand that audit quality indicators are a separate research project on the Board's docket, that should not prevent the inclusion of a minimum number of such indicators in the quality control standard. More indicators can be added as progress is made on the research project.

To that end, we recommend a minimum requirement of eight indicators as part of the quality control standard. *All of them have been drawn from the PCAOB's 2015 Audit Quality Indicator Concept Release*².

1. Staffing Leverage. The "staffing leverage" indicator measures the time of experienced senior personnel relative to the volume of audit work they oversee.

2. Partner Workload. The "partner workload" indicator generates data about the level of work for which the audit engagement partner is responsible and the number of claims on his or her attention.

3. Manager and Staff Workload. This indicator would provide information about the workload of audit managers and audit staff.

4. Audit Hours and Risk Areas. This indicator measures the time spent by members of the audit team at all levels on risk areas identified by the firm during audit planning.

5. Quality Ratings and Compensation. This indicator measures the potential correlation between high quality ratings and compensation increases and the comparative relationship between low quality ratings and compensation increases or decreases.

6. Audit Fees, Effort, and Client Risk. This indicator provides insight into the relationship between engagement or firm audit fees and hours, on the one hand, and levels of client risk, on the other.

7. Audit Firms' Internal Quality Review Results. This Indicator contains information about the internal quality reviews conducted by each audit firm.

8. PCAOB Inspection Results. This indicator contains information about PCAOB inspection results relating to the engagement or the audit firm involved.

While we would prefer a more complete set of audit quality indicators, we believe that these would be an effective starting set for integration into the design of a quality control system.

Roles And Responsibilities. We note that the proposal calls for the certification of a firm's quality control system by the principal executive officer, similar to the attestation of the chief executive officer on financial statements. We believe that this is an ineffective incentive for making quality control a higher priority within a firm. We believe that it would be a far more effective improvement to audit quality, with more pervasive effects within a firm, if partner compensation was also weighted heavily towards the design and effective functioning of a quality control system. We believe that the principal executive officer signing off on the control system is a good psychological ploy for motivating one person to motivate others, but it doesn't carry the same broad-based firm-wide incentive as having many partners compensated based on the effectiveness of the firm's quality control system.

² PCAOB Release No. 2015-005, "Concept Release On Audit Quality Indicators," July 1, 2015, at https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket_041/release_2015_005.pdf?sfvrsn=de838d9f_0

The Firm’s Risk Assessment Process

We believe that the proposed definitions and terminology contained within this section of the proposal are clear and appropriate.

Governance and Leadership

See our previous comments regarding incentives, as they relate to governance and leadership within auditing firms.

We also believe that there should be no distinction between firms that issue audit reports to less than 100 issuers versus those who issue audit reports for more than 100 issuers. While this is a “scalable” criterion, it creates a threshold for firms to stay just below the 100-issuer line so as to avoid additional effort to maintain a quality control system. This is an example of where our recommendation to issue minimum standards for issuers would help improve audit quality.

For all aspects of the proposal, if bright-line type of threshold is to be maintained, we find the 100-issuer threshold to be arbitrary and likely ineffective. We have observed tiny firms allegedly auditing \$32 billion companies, while outside of the PCAOB’s regulatory purview. The same thing could happen with tiny firms within the PCAOB’s regulatory reach. We suggest that thresholds based on market capitalization of firms audited be the bright line used for determining firms to be scoped into or out of the PCAOB standard.

Ethics and Independence

In addition to the annual written independence certification, we recommend that the proposed standard requires an annual written certification regarding familiarity and compliance with ethics requirements and the firm’s ethics policies and procedures. This would be at the very least a reminder to employees of their duty to their employer and the consequences of failing to abide by the firm’s ethic requirements.

Engagement Performance

We have expressed some reservations about over-reliance on a risk-based approach previously, and this extends to our view on the elimination of the current Appendix K requirement. We would prefer to see the Appendix K requirement retained, and in fact, extended to all non-U.S. firms that audit issuers.

Evaluating and Reporting on the QC System

We believe that November 30 is an appropriate evaluation date for firms to conclude on the effectiveness of the QC system. It blends in well with the time of year that most firms will become enmeshed in auditing duties. We would not recommend that firms be allowed to set their own reporting date.

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If you, any members of the Board, or your staff have questions or seek further elaboration of our views, please contact Amy McGarrity at amcgarrity@copera.org.

Sincerely,

Members of the Investor Advisory Group

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