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Office of the Secretary
PCAOB
1666 K Street, NW
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BY ELECTRONIC SUBMISSION
Re: PCAOB Rulemaking Docket Matter No. 046

To the Board and Staff of the PCAOB:

It is my honor to provide these comments on the exposure draft of QC 1000, a firm's system of quality control.

By way of introduction, I am a long-time institutional investor who has been the investment manager or fiduciary for more and \$100 billion in assets. I am vitally interested in protecting the quality of accounting and auditing. I believe that is a prerequisite to fulfilling the audit profession's public purpose of providing high-quality information so as to allow the proper functioning of the capital markets. I have been a member of both the WorldCom and Adelphia official creditors' committee, two of the biggest frauds and bankruptcies in history, so I understand what happens when audit quality doesn't exist.

I am member of Deloitte's Audit Quality Advisory Committee (AQAC), the PCAOB's Standards and Emerging Issues Advisory Group (SEIAG), and the Corporate Oversight and Governance Advisory Board (COGB) of CPA Canada. I was formerly a member of the PCAOB's Standing Advisory Group (SAG)¹ and CPA Canada's Foresight Group.

What follows are my personal opinions; nothing in this submission should be taken to mean that any member of Deloitte's management or the AQAC or the members of the AQAC, the SEIAG or the PCAOB or their members, the COGB or its members or CPA Canada necessarily agree with any of my comments. They are solely my own opinions.

First, let me congratulate the PCAOB. While efforts to maintain and improve audit quality at the engagement level are important, a firm's system of quality control is the necessary complement. Combining a robust firmwide system of quality control with engagement-level efforts will result in an audit-quality sum greater than the two parts.

¹ As the QC 1000 exposure draft notes the PCAOB has explored the need for a new QC standard for more than a decade. As a member of the SAG during some of those discussions, I supported (and obviously continue to support) that effort, and can attest that the exposure draft is correct when it states, on page 18, that SAG members were generally supportive of efforts to include firm leadership, governance and culture in a QC standard.

However, I do believe there is missing context to the proposed QC 1000; there should be an explicit acknowledgement that auditing serves a public purpose and that the system of quality control therefore should serve investors and the capital markets as much as – and probably more than – it serves the firms and the issuers.

That is why I have emphasized ethics and public purpose in my comments. As an investor, it is clear to me that auditors who understand and respect the public purpose of the profession strive to have the necessary skills and mindset to perform quality audits. On the other hand, auditors inclined to take shortcuts, no matter how experienced, and no matter what the firms' systems of quality control, are quality risks. To be clear, my experience is that the majority of auditors and audit firms take audit quality seriously and have appropriate ethical standards (including independence) and act accordingly. However, scandals such as cheating on the ethics portions of state licensing exams, or seeking inside knowledge of the PCAOB's intended audit selections for its inspection program or manipulated work papers after they are selected for inspection suggest that some auditors regard ethical considerations and audit quality requirements as a game and they try to win by finding the cheat code.² Such ethical lapses not only affect audit quality but also public confidence in the profession. I don't know how an investor could trust an audit opinion signed by someone who would cheat on an ethics exam or use insider knowledge to try to rig a PCAOB inspection. They raise doubts as to whether auditors are committed to the public purpose of auditing and understand that following the rules is how that public purpose is fulfilled. Again, I have no doubts that the vast majority of auditors find such behaviors as abhorrent as I do. My hope is that a robust QC 1000, with an emphasis on ethics and purpose, can help move that proportion from the majority to virtually all.

Here are my specific comments to some of the exposure draft's questions. Please note that I have only chosen to respond to a subset of the questions asked in the exposure draft.

Q1: "Is the proposed definition of "applicable professional and legal requirements" appropriate? Are there elements that should be excluded, or other requirements that we should include? If so, what are they?"

A: I believe that the proposed definition of "applicable professional and legal requirements" is too narrow, in that it does not explicitly include the profession's ethical standards. It should be broadened to add the applicable ethical standards of the PCAOB, SEC, state and foreign accounting licensing authorities, and IESBA.

Q5: "Is it appropriate for the proposed standard to require firms that have not and do not plan to perform engagements pursuant to PCAOB standards to design a QC system in

² See, generally, footnotes 57-64 in the exposure draft.

accordance with QC 1000? Why or why not? Would this requirement impose disproportionate costs on small firms? Please provide data or estimates, if available, on such costs.”

A: It is not only appropriate, but important that the standards do so. As Senators Warren and Wyden note in their recent letter to the PCAOB, when private companies such as FTX collapse, the knock-on effects create doubt about the quality of audits generally. While the PCAOB does not have authority over the audits at private firms, the fact that two PCAOB-licensed firms were involved as auditors of some portions of the FTX complex raises questions about the dedication to audit quality at those firms. Mandating that all PCAOB-licensed firms have a QC system in accordance with QC 1000 would mean that the firms would know the system of quality control for public companies. They would be aware of the processes and controls for audits performed under a system of quality control aligned with QC 1000 and how those processes and controls compare to those which are not. And, of course, private clients or the audit firms themselves could, at their own discretion, insist upon their audits being done under the QC 1000 standards, which would provide an additional layer of voluntary quality control to those audits. Additionally, the firms would undoubtedly learn of audit quality risks that cut across both public company and private company audits. One could infer a great deal about the professionalism of those firms which if they chose to not address them for private issuers, compared to those that do.

Q 18: “Are the proposed requirements for the firm’s risk assessment process appropriate? Are changes to the requirements necessary for this process? If so, what changes?”

A: I suggest three additions

- As the proposal explicitly notes, change is constant, and that these can affect the specific manifestations of quality risks. I therefore suggest that the firms be required to create, as part of the firm’s system of quality control, an individual or other entity charged with maintaining situational awareness. While the requirements state the firms should be aware of changes that create quality risks, I suggest that there be a specific requirement to identify a mechanism to do so. My personal expertise is in the financial sector, so I will use the following example: Beginning in late 2021, I had discussions that rising interest rates and the end of a very loose liquidity regime could create going concern questions for some issuers (as has now happened with crypto “exchanges” and others in the crypto ecosystem and some cash-flow-negative speculative companies). Mandating some mechanism or accountability for situational awareness would be additive to the entire system of quality control.
- There should be a requirement for a whistleblower mechanism within the system of quality control. It should include protections for whistleblowers (ability to report anonymously if desired, no retribution, etc.) and a requirement that the individual responsible for the system of quality control also be responsible for appropriately investigating whistleblower complaints related to quality issues, and remediation of issues brought to the firm’s attention via a whistleblower reporting mechanism.
- Compensation’s impacts on firm culture should be considered. As the exposure draft notes, previous SAG discussions supported considering a firm’s governance structures

and culture as a key to audit quality. A governance tenet is that compensation incents behavior, and it is as true for audit firms as it is for issuers. While the requirements talk about resources, they do not specify the compensation structure at the firm as part of the system of quality control or as a potential source of quality risk. The individual responsible for the system of quality control should also be responsible for ensuring that the compensation policies of the firm do not create quality risks and, in fact, are aligned with promoting audit quality.

Q 30. "In addition to the annual written independence certification, should the proposed standard require an annual written certification regarding familiarity and compliance with ethics requirements and the firm's ethics policies and procedures? Why or why not? Should firms be required or encouraged to adopt firm-wide codes of ethics or similar protocols? Why or why not? Are there other specific policies that QC 1000 should require or encourage to promote ethical behavior?"

A: Yes. This is a vital need, and some firms already do this. As I wrote in the introduction to this submission, all these obligations need to be anchored to the firm's public purpose and ethical requirements. Auditors should be reminded, at least annually, that there is a public purpose to auditing, and that the rules exist for a reason. This "nudge" behavioral-modification tool is low-cost, both provides a rallying point for those within a firm who seek and applaud ethical behavior and a behavioral nudge to those who might otherwise succumb to the day-to-day pressures that might otherwise compromise the conditions necessary for independence and other ethical behavior. The main arguments against such annual affirmations are that it imposes a cost and that it becomes a tick-the-box exercise. I maintain that the cost is de minimus given that other annual declarations need to be made by firm personnel, so a mechanism for tracking such declarations already exists (for instance the firm-wide tracking of CPE credits). In addition, some firms already do this, which suggests that the cost is not a deterrent and that they recognize it as a benefit and cost-effective. Insofar as the devolution of such an annual declaration to a perfunctory exercise, that can (and should) be combatted by firm leadership embracing the ethics code, which would also send an appropriate signal.

Q 61: "Should firms be required to report on the evaluation of the QC system to the PCAOB? If not, why not?"

A: Yes. Such reports will assist the PCAOB in its prudential regulatory function and in future standard setting.

Q 69: "In light of the legal constraints of Sarbanes-Oxley with respect to public reporting regarding QC matters, are there other public reporting alternatives that should be considered? What would be the potential costs and benefits of such alternatives?"

A: Within the current public disclosure constraints, I suggest two additional measures.

- Firms should affirm to the PCAOB on form QC that any information that the firms voluntarily released (e.g. in transparency reports, audit quality reports, speeches by CEOs, etc.) over the time period covered by form QC was consistent with the state of their quality control system, as of the time the voluntary disclosure. This would help prevent “quality-washing” in those public documents.
 - As that affirmation does not reveal any of the firm’s QC deficiencies and only relates to the information that the firm has previously released voluntarily, that affirmation should be publicly available.
- The PCAOB should have the ability to use the information in form QC on an aggregate and anonymized basis, to report on the state of the profession’s systems of quality control.

I thank you for the opportunity to comment.

Sincerely,
Jon Lukomnik