



Via Email

September 17, 2015

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

Re: *Concept Release on Audit Quality Indicators (PCAOB Rulemaking Docket Matter No. 041)*<sup>1</sup>

Dear Madam Secretary:

The Council of Institutional Investors (CII) appreciates the opportunity to provide comments on the Public Company Accounting Oversight Board's (PCAOB or Board) concept release on audit quality indicators (Release).<sup>2</sup> CII is a non-profit, non-partisan, association of pension funds, other employee benefit funds, endowments and foundations with combined assets that exceed \$3 trillion.<sup>3</sup>

As the leading voice for effective corporate governance and strong shareowner rights, CII believes that accurate and reliable audited financial statements are critical to investors in making informed investment decisions, and vital to the overall well-being of our capital markets.<sup>4</sup> That strong belief is reflected in the following CII membership-approved policy on the "Independence of Accounting and Auditing Standard Setters":

Audited financial statements including related disclosures are a critical source of information to institutional investors making investment decisions. The efficiency of global markets—and the well-being of the investors who entrust their financial present and future to those markets—depends, in significant part, on the quality, comparability and reliability of the information provided by audited financial statements and disclosures. The quality, comparability and reliability of that information, in turn, depends directly on the quality of the . . . standards that . . . auditors use in providing assurance that the preparers' recognition, measurement and disclosures are free of material misstatements or omissions.<sup>5</sup>

<sup>1</sup> PCAOB Release No. 2015-005 (July 1, 2015), [http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release\\_2015\\_005.pdf](http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf).

<sup>2</sup> *Id.*

<sup>3</sup> For more information about the Council of Institutional Investors ("CII"), please visit CII's website at <http://www.cii.org/>.

<sup>4</sup> Council of Institutional Investors, Policies on Other Issues, Independence of Accounting and Auditing Standard Setters (Adopted Oct. 7, 2008), [http://www.cii.org/policies\\_other\\_issues#indep\\_acct\\_audit\\_standards](http://www.cii.org/policies_other_issues#indep_acct_audit_standards).

<sup>5</sup> *Id.*

This policy establishes the principle that “investors are the key customer of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy in a timely manner investors’ information needs.”<sup>6</sup> Our membership reaffirmed that principle in 2013 when it approved substantial revisions to our policy on “auditor independence.”<sup>7</sup> That policy and the related revisions include the following provisions that we believe are particularly relevant to issues raised by the Release:

**2.13a Audit Committee Responsibilities Regarding**

**Independent Auditors:** The audit committee should fully exercise its authority to hire, compensate, oversee and, if necessary, terminate the company’s independent auditor. In doing so, the committee should take proactive steps to promote auditor independence and audit quality. Even in the absence of egregious reasons, the committee should consider the appropriateness of periodically changing the auditor, bearing in mind factors that include, but are not limited to:

- the auditor’s tenure as independent auditor of the company
- the presence of former audit partners, managers or senior officers in financial reporting or executive positions at the company, or former financial executives of the company in lead offices performing audit work on the company
- directors’ relationships with the auditor, including through directors’ employer and service on other audit committees
- the proportion of total fees attributable to non-audit services, and a determination of why these services could not have been provided by another party to safeguard the auditor’s independence
- the completeness, timeliness and clarity of the annual letter to the audit committee discussing the independence of the auditor
- the significance of the audit and total fees to the lead office and engagement partner performing the independent audit
- the quality and frequency of communication from the auditor to the audit committee
- the experience, expertise and professional skepticism of the audit partner, manager and senior personnel assigned to the audit, and the extent of their involvement in performing the audit

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<sup>6</sup> *Id.*

<sup>7</sup> Council of Institutional Investors, Corporate Governance Policies § 2.13 Auditor Independence (last updated Apr. 1, 2015), [http://www.cii.org/corp\\_gov\\_policies#BOD](http://www.cii.org/corp_gov_policies#BOD).

- the incidence and circumstances surrounding a financial restatement, whether at the company or at another company audited by the same firm
- the incidence and circumstances surrounding the reporting of a material weakness in internal controls by the auditor
- the clarity, utility and insights provided in the auditor's report and the auditor's letter to management in relation to the audit
- the level of transparency and robustness of the audit firm with the audit committee and investors, including with respect to audit quality indicators, governance practices and underlying principles, and the financial stability of the audit firm
- inspection results and fines levied by the Public Company Accounting Oversight Board or other regulators
- the track record of the lead partners and the extent of their professional commitments, as provided upon request or observable through disclosure or signature of the lead partner on the auditor's report
- reasons cited by other companies for discontinuing their engagement of the same audit partner and/or auditor
- the results of annual auditor performance review by audit committee members
- the availability of a replacement for the existing auditor with the requisite experience and staffing required by professional standards to perform a quality audit
- the auditor's position on whether it requires the inclusion of an arbitration clause that would place limitations on investors' ability to recover damages they have incurred

Investors are the "customers" and end users of financial statements and disclosures in the public capital markets. Both the audit committee and the auditor should recognize this principle.

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**2.13f Shareowner Votes on the Board's Choice of Outside Auditor:** Audit committee charters should provide for annual shareowner votes on the board's choice of independent, external auditor. Such provisions should state that if the board's selection fails to achieve the support of a majority of the for-and-against votes cast, the audit committee should: (1) take the shareowners' views into consideration and reconsider its choice of auditor and (2) solicit the views of major shareowners to determine why broad levels of shareowner support were not achieved.<sup>8</sup>

Generally consistent with our policies, CII strongly supports the Board's efforts to implement the recommendation of the Department of the Treasury's Advisory Committee on the Auditing Profession (ACAP) to develop "key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose those indicators [AQI's]."<sup>9</sup> We believe that in order to cast an informed vote on auditor selection and effectively engage the board if needed, long-term investors require information surrounding factors materially affecting audit quality.<sup>10</sup> If, however, requiring public AQI's is not viewed as an objective of this project, we would respectfully request that the Board promptly consider dropping this project from its agenda and reallocating its limited resources to other projects and activities that are intended to directly and substantially benefit investors.<sup>11</sup>

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<sup>8</sup> *Id.*

<sup>9</sup> United States Department of the Treasury, Final Report, Advisory Committee on the Auditing Profession VIII:14 (Oct. 6, 2008), <http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>. We note that the Final Report represented one of the most comprehensive studies of the auditing profession in U.S. history and included a "philosophically diverse, talented, and committed group of investor, business, academic, and institutional leaders," ably lead by co-chairs Arthur Levitt, Jr., and Donald T. Nicolaisen. Advisory Committee on the Auditing Profession II:2.

<sup>10</sup> See Letter from Jonathan D. Urick, Analyst, Council of Institutional Investors, to J. Gordon Seymour, Secretary and General Counsel, Public Company Accounting Oversight Board 2 (Sept. 4, 2009) (on file with CII); see also Advisory Committee on the Auditing Profession VIII:15 ("with the majority of public companies currently putting shareholder ratification of auditor selection to an annual vote, shareholders may also lack audit quality information important in making such a ratification decision").

<sup>11</sup> Other existing Public Company Accounting Oversight Board projects that are more likely to directly and substantially benefit investors include "proposed changes to its auditing standards and rules that can provide new information to shareholders about the most critical issues addressed by the auditor . . . and the identity of the engagement partner and certain other participants in the audit." PCAOB Release No. 2015-005, at 23 n.33.

Our detailed views in response to the following select questions contained in the Release follows:

**27. To what extent would engagement-level AQI's be useful to investors? AQI firm-level data for the engagement firm? What AQI's would be most useful? Why?**<sup>12</sup>

CII generally believes that a “portfolio of properly chosen AQI's” of engagement-level and firm-level data would be useful to investors.<sup>13</sup> As indicated in the Release, “investors are the primary beneficiaries of the financial reporting process and the group at which audit quality is ultimately aimed,” yet investors have limited data available to them regarding audit quality.<sup>14</sup>

As further explained in the Release:

At present, the visibility of the sources of audit quality to investors is even more limited than it is to audit committees. Investors have no direct channel to the auditor: communication is typically restricted to the standard auditor's report about a company's financial statements and internal control over financial reporting.

[Existing data on audit quality,] do not often help investors focus on the components of the audit process and, more important, provide little information *about how quality audits are planned and executed*.<sup>15</sup>

As similarly noted by prominent accounting analyst Jack Ciesielski:

*[T]he PCAOB's audit quality indicator project . . . [is] the most promising . . . in terms of bringing information to investors that they can actually use. The process of selecting auditors and paying them is a pretty mindless affair – it's in the hands of the audit committee, who pledges that they've done right by investors in selecting and recommending the auditor, just like the audit opinion is the pledge of the auditor that they've done right by investors. If the PCAOB can get those AQI's in front of investors, they'll be able to assess the veracity of those two pledges.*<sup>16</sup>

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<sup>12</sup> *Id.* at 29.

<sup>13</sup> *Id.* at 24.

<sup>14</sup> *Id.* at 22.

<sup>15</sup> *Id.* at 23.

<sup>16</sup> Jack T. Ciesielski, Can Regulators Make Audits Matter More? Three Proposals Offer Some Hope, 24 Analyst's Acct. Observer 2 (July 29, 2015) (on file with CII).

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As indicated in the basis and intent of our policy on “Audit Committee Responsibilities Regarding Independent Auditors,” we believe that AQI’s could provide useful information to shareowners in their role of overseeing the audit committee’s activities and casting their votes in connection with the ratification of the audit committee’s selection of the external auditor and in connection with the election of the audit committee chair.<sup>17</sup>

We note that the ACAP similarly concluded, more than six years ago, that “requiring firms to disclose indicators of audit quality may enhance not only the quality of audits provided by such firms, but also . . . shareholder decision making related to ratification of auditor selection . . . .”<sup>18</sup>

More broadly, we generally agree with the Release that AQI’s could also benefit investors by:

[B]etter distinguish[ing] variations in measures that relate to quality [and producing] . . . greater market differentiation among audits and stimulate competition in quality that may also have an effect on securities prices. This in turn could generally help investors given the public goods nature of the securities prices.<sup>19</sup>

This broader view of the benefit to investors from AQI’s was supported by the findings and recommendation of the ACAP, including notably a written submission from the then Chairman of PricewaterhouseCoopers LLP indicating that disclosure of AQI’s “would be a useful benefit to the capital markets.”<sup>20</sup>

Consistent with our membership approved policy, we believe the following AQI’s referenced in the Release are among the portfolio of indicators that are likely to be most useful to long-term shareowners:<sup>21</sup>

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<sup>17</sup> See §2.13a Audit Committee Responsibilities Regarding Independent Auditors; see *also* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Secretary, Securities and Exchange Commission 6 (Aug. 19, 2015) (“we generally believe that . . . our membership approved proposed audit committee disclosures would enhance the ability of shareowners to oversee the audit committee’s activities [] . . . and importantly, the disclosures would provide an additional basis upon which shareowners can cast their votes in connection with the ratification of the audit committee’s selection of the external auditor and in connection with the election of the audit committee chair”), <http://www.cii.org/correspondence>.

<sup>18</sup> Advisory Committee on the Auditing Profession VIII:15.

<sup>19</sup> PCAOB Release No. 2015-005, at 24.

<sup>20</sup> Advisory Committee on the Auditing Profession VIII:16 n.56.

<sup>21</sup> See § 2.13a.

### Partner Workload<sup>22</sup>

We generally agree with the Release that:

[H]eavy workloads could distract an engagement partner from giving adequate and focused attention to an audit engagement. The figures generated by this indicator can help bring that issue to light and aid understanding of the implications of division of a partner's attention among several audit clients and competing deadlines.<sup>23</sup>

We note that this potential AQI is generally consistent with an AQI that was explicitly identified and recommended by an "Anonymous Retired Big 4 partner," during the development of the ACAP recommendation.<sup>24</sup> The Anonymous Retired Big 4 Partner described the AQI in terms of "professional chargeable hours managed per audit partner."<sup>25</sup> In our view, this input was highly influential to the ACAP's findings and recommendation requiring audit firms to publicly disclose AQI's.

Finally, we note that the Center for Audit Quality (CAQ) also appears to support requiring the disclosure of a partner workload AQI, explaining:

Workload related indicators could assist audit committees in better understanding whether engagement teams have appropriate time to perform the audit, review and supervise the audit work, and address difficult issues, if and why they arise. Key engagement team members usually work on a number of audits, some with similar reporting timetables. This can lead to concentrated periods of activity. Key engagement team members also have additional responsibilities (such as recruiting, practice development and technical or management roles). A workload AQI may, therefore, be a good indicator of partner(s)' . . . capacity to effectively supervise the audit, review the work of subordinates, and execute audit procedures.<sup>26</sup>

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<sup>22</sup> PCAOB Release No. 2015-005, at A-3; see § 2.13a ("the track record of the lead partners and the extent of their professional commitments, as provided upon request or observable through disclosure or signature of the lead partner and/or auditor").

<sup>23</sup> PCAOB Release No. 2015-005, at A-3.

<sup>24</sup> Advisory Committee on the Auditing Profession VIII:16 n.56.

<sup>25</sup> *Id.*

<sup>26</sup> Center for Audit Quality, CAQ Approach to Audit Quality Indicators 11 (Apr. 2014), <http://www.thecaq.org/reports-and-publications/caq-approach-to-audit-quality-indicators/caq-approach-to-audit-quality-indicators>.

### Experience of Audit Personnel<sup>27</sup>

We generally agree with the Release that:

Auditors with relevant experience, both in general and with a particular client, may be able to approach the audit in a more knowledgeable and effective manner.<sup>28</sup>

We again note that this potential AQI was identified and recommended by an “Anonymous Retired Big 4 partner,” in a comment letter to the ACAP.<sup>29</sup> The Anonymous Retired Big 4 partner described the AQI in terms of “average years of experience of audit professionals.”<sup>30</sup> And again, in our view, this input was highly influential in the ACAP’s findings and recommendation requiring audit firms to publicly disclose AQI’s.

Finally, we note that the CAQ also appears to support requiring disclosure of an AQI on experience of audit personnel, noting:

The . . . experience . . . of the audit engagement partner and certain other members of the engagement team are important elements in the execution of an audit. It is the responsibility of the engagement partner to determine that, collectively, the engagement team has the appropriate experience and competencies . . . .”

The collective knowledge and experience of the engagement team is important for achieving audit quality. These indicators are intended to help an audit committee understand the structure of the engagement team and illustrate certain information relative to the knowledge, relevant experience (such as auditing complex group structures or other companies in a similar industry) and the tenure of key engagement team members.<sup>31</sup>

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<sup>27</sup> PCAOB Release No. 2015-005, at A-6; see § 2.13a (“the experience, expertise and professional skepticism of the audit partner, manager and senior personnel assigned to the audit, and the extent of their involvement in performing the audit”).

<sup>28</sup> PCAOB Release No. 2015-005, at A-6.

<sup>29</sup> Advisory Committee on the Auditing Profession VIII:16 n.56.

<sup>30</sup> *Id.*

<sup>31</sup> CAQ Approach to Audit Quality Indicators at 8.



PCAOB Inspection Results<sup>32</sup>

We generally agree with the Release that:

[PCAOB inspection results] can provide insight, in their Part I findings (and any quality control defects, described in Part II of an inspection report, that becomes available if adequate remediation by firms with quality control defects does not occur), about breakdowns that may cause audit deficiencies. Public inspection findings may cause audit deficiencies. Public inspection findings may provide a baseline for evaluating other indicators (e.g., comparing staff utilization rates, or use of persons with specialized skill and knowledge, with inspection findings) and testing the efficiency of firms' internal quality control systems.<sup>33</sup>

In addition, we note that the CAQ also appears to support requiring disclosure of an AQI on PCAOB inspection results acknowledging that “[c]ompliance with professional standards in the execution of an audit is partially assessed through inspection processes conducted by the PCAOB . . . .”<sup>34</sup>

Frequency and Impact of Financial Statement Restatements for Errors<sup>35</sup>

We generally agree with the Release that:

The number and impact of restatements for errors . . . . are generally considered a signal criterion of potential difficulties in at least parts of an auditor's practice and approach to auditing.<sup>36</sup>

We note that this potential AQI was explicitly identified and recommended by CII member California Public Employees' Retirement System (CalPERS) in a comment letter to the ACAP.<sup>37</sup> CalPERS described the potential AQI in more qualitative terms regarding “the nature and reason for client restatements.”<sup>38</sup>

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<sup>32</sup> PCAOB Release No. 2015-005, at A-18; see § 2.13a (“inspection results and fines levied by the Public Company Accounting Oversight Board or other regulators”).

<sup>33</sup> PCAOB Release No. 2015-005, at A-18.

<sup>34</sup> CAQ Approach to Audit Quality Indicators at 12.

<sup>35</sup> PCAOB Release No. 2015-005, at A-19; see § 2.13a (“the incidence and circumstances surrounding a financial statement, whether at the company or at another company audited by the same firm”).

<sup>36</sup> PCAOB Release No. 2015-005, at A-9.

<sup>37</sup> Advisory Committee on the Auditing Profession VIII:16 n.56.

<sup>38</sup> *Id.*

In our view, this input was highly influential to the ACAP's findings and recommendation requiring audit firms to publicly disclose AQI's and should be incorporated into the more quantitative potential AQI described in the Release.

Finally, we note that the CAQ also appears to support requiring disclosure of an AQI focused on restatements, acknowledging that "[t]he level of reissuance restatements of previously issued financial statements by public companies . . . is considered by some to be a potential indicator of audit quality."<sup>39</sup>

#### Timely Reporting of Internal Control Weaknesses<sup>40</sup>

We generally agree with the Release that:

"[E]ffective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes." A firm's failures to identify material internal control weaknesses may raise issues about staffing, training, or audit focus for these important issues.<sup>41</sup>

In addition, we note that the CAQ also appears to support requiring disclosure of an AQI focused on "instances where the auditor has withdrawn its previously issued report on internal controls over financial reporting [and acknowledges that] (ICFR) is considered by some to be a potential indicator of audit quality."<sup>42</sup>

#### Results of Independent Surveys of Audit Committee Members<sup>43</sup>

Finally, we generally agree with the Release that:

Communication between auditors and audit committees is at the center of the audit process.

Data from anonymous independent surveys of audit committee members could provide uniquely valuable information about the way auditors actually interact with audit committees.<sup>44</sup>

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<sup>39</sup> CAQ Approach to Audit Quality Indicators at 13.

<sup>40</sup> PCAOB Release No. 2015-005, at A-22; see § 2.13a ("the incidence and circumstances surrounding a financial statement, whether at the company or at another company audited by the same firm").

<sup>41</sup> *Id.* at A-23 (footnote omitted).

<sup>42</sup> CAQ Approach to Audit Quality Indicators at 13.

<sup>43</sup> PCAOB Release No. 2015-005, at A-24; see § 2.13a ("the results of annual auditor performance reviews by audit committee members").

<sup>44</sup> PCAOB Release No. 2015-005, at A-24 (footnote omitted).

**28. Should engagement level AQI data be made public in whole or part? Should firm level AQI data be made public in whole or part?**<sup>45</sup>

CII strongly believes that engagement level and firm level AQI data should be made public in whole. As the Release acknowledges “[i]nvestors could only use AQI information if, when, and to the extent that information is made publicly available.”<sup>46</sup>

As indicated in our membership approved policy on “Audit Committee Responsibilities Regarding Independent Auditors”:

‘investors’ are the ‘customers’ and end users of financial statements and disclosures in the public capital markets. Both the audit committee and the auditor should recognize this principle.<sup>47</sup>

The basis and intent of our membership approved policy indicates that AQI type factors may be useful to the customers of audited financial statements when as shareowners they seek to develop a basis upon which to cast votes on proposals to ratify the selection of the auditor<sup>48</sup> or in the election of the audit committee chair.<sup>49</sup> That view is entirely consistent with the findings and recommendation of the ACAP which stated that they “believe[] that requiring firms to disclose indicators of audit quality may enhance . . . shareholder decision making related to ratification of auditor selection . . . .”<sup>50</sup>

We are deeply disappointed that some commentators appear to be suggesting that the customers of audited financial statements should be denied access to AQI’s because of concerns about “[w]hether investors could really evaluate the quality of audits based on the AQIs . . . .”<sup>51</sup> Unfortunately, those concerns are likely a manifestation of the long-standing and deeply rooted problem that continues to plague the auditing profession to this day—auditors simply do not view investors as the customer of their service.<sup>52</sup>

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<sup>45</sup> *Id.* at 29.

<sup>46</sup> *Id.* at 18 n.22.

<sup>47</sup> § 2.13a.

<sup>48</sup> See PCAOB Release No. 2015-005, at 22 n.32 (“Data obtained from Audit Analytics indicates that 90 percent of the public companies on the Russell 3,000 list as of April 2014 submitted at least one auditor ratification proposal to shareholders between 2011-13.”).

<sup>49</sup> Letter from Jeff Mahoney at 6.

<sup>50</sup> Advisory Committee on the Auditing Profession VIII:15.

<sup>51</sup> Morgan Lewis, White Paper, New SEC and PCAOB Proposals Related to Audit Committee Disclosure and Audit Quality 15 (July 2015) (“Whether investors could really evaluate the quality of audits based on the AQI’s is a significant issue that commentators are likely to address.”), <http://www.morganlewis.com/pubs/new-sec-and-pcaob-proposals-related-to-audit-committee-disclosure-and-audit-quality>.

<sup>52</sup> See, e.g. Matt Waldron, Who is the Auditor’s Client? ‘Addressing the Elephant in the Room’ Market Integrity Insights, CFA Institute 1 (Nov. 4, 2014) (commenting that most auditors view the company rather than investors as their client), <https://blogs.cfainstitute.org/marketintegrity/2014/11/04/who-is-the-auditors-client-addressing-the-elephant-in-the-room/>.

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In that regard, from our perspective, the greatest potential benefit of the AQI project is that it could result in meaningful public information that would assist and encourage investors to be more vigilant when considering their votes for whether to ratify the external auditor and elect the chair of the audit committee. A more energized and informed shareowner vote on ratification and audit committee chair may well be the most cost effective means currently available to remove the scales from the eyes of the independent auditor so they might finally see who truly is the customer of the audit.<sup>53</sup>

For all of the above reasons, if requiring public AQI's is not an objective of this project, we would respectfully request that the Board promptly consider dropping this project from its agenda and reallocating its limited resources to other projects and activities *that are intended to directly and substantially benefit investors*—the customers of audited financial reports.

CII appreciates your consideration of our views in response to the Release. Please do not hesitate to contact me if you have any questions or would like any additional information about the content of this letter.

Sincerely,



Jeff Mahoney  
General Counsel

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<sup>53</sup> See *id.* (describing a six step alternative audit firm business model presented at a meeting of the PCAOB Investor Advisory Group); see generally Acts 9:18 (King James) (“And immediately there fell from his eyes as it had been scales: and he received sight forthwith . . .”), <http://biblehub.com/acts/9-18.htm>.