Council of Institutional Investors®
The voice of corporate governance

Via Email

January 19, 2023

Ms. Phoebe W. Brown
Office of Secretary
Public Company Accounting Oversight Board
1616 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket No. 046: A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms[1]

Dear Secretary Brown:

The Council of Institutional Investors (CII) appreciates the opportunity to share our views and provide input on the Public Company Accounting Oversight Board's (PCAOB or Board) Release No. 2022-006, *A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms* (Proposal).[2]

CII is a nonprofit, nonpartisan association of U.S. public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately $4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families, including public pension funds with more than 15 million participants – true "Main Street" investors through their pension funds. Our associate members include non-U.S. asset owners with about $4 trillion in assets, and a range of asset managers with more than $35 trillion in assets under management.[3]

CII Policies

As the leading U.S. voice for effective corporate governance and strong shareholder rights, CII believes that accurate and reliable audited financial statements are critical to investors in making informed decisions, and vital to the overall well-being of our capital markets.[4] That belief is

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[1] A Firm's System of Quality Control And Other Proposed Amendments to PCAOB Standards, Rules, and Forms, PCAOB Release No. 2022-006 (Nov. 18, 2022), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket046/2022-006-qc.pdf?sfvrsn=b89546e2_2.
[2] *Id.*
[3] For more information about the Council of Institutional Investors ("CII"), including its board and members, please visit CII's website at http://www.cii.org.
[4] CII, Policies on Other Issues, Independence of Accounting and Auditing Standard Setters (updated Mar. 1, 2017), http://www.cii.org/policies_other_issues#indep_acct_audit_standards.

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.[5]

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."[6] Our membership reaffirmed that principle in our policy on **Auditor Independence**.[7] That policy, as revised, includes the following additional provisions that we believe may be relevant to issues raised by the Proposal.

> **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:
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> ….
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> - 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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> ….
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> - the quality and frequency of communication from the auditor to the audit committee
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> ….
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> - enforcement actions (in process or completed), inspection results and fines levied by the Public Company Accounting Oversight Board or other regulators

5 *Id.*
6 *Id.*
7 CII, Policies on Corporate Governance § 2.13 Auditor Independence (updated Sept. 21, 2022), https://www.cii.org/corp_gov_policies.

- 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

. . . .

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.

. . . .

Audit Committee Charters: The proxy statement should include a copy of the audit committee charter and a statement by the audit committee that it has complied with the duties outlined in the charter.

. . . .

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.

Disclosure of Reasons Behind Auditor Changes: The audit committee should publicly provide to shareowners a plain-English explanation of the reasons for a change in the company's external auditors. At a minimum, this disclosure should be contained in the same Securities and Exchange Commission (SEC) filing that companies are required to submit within four days of an auditor change.[8]

Other CII membership approved policies regarding **The Board of Directors**[9] that we believe may be relevant to this Proposal including the following:

Independent Board: . . . The company should disclose information necessary for shareowners to determine whether directors qualify as independent. . . .

. . . .

All-independent Board Committees: Companies should have audit, nominating and compensation committees, and all members of these committees should be independent. . . . . The process by which committee members and chairs are selected should be disclosed to shareowners.[10]

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[8] *Id.*
[9] CII, Policies on Corporate Governance § 2 The Board of Directors.
[10] *Id.*

In furtherance of the language and intent of our membership approved policies, and building on our March 2020 letter[11] in response to the related Concept Release, *Potential Approach to Revisions to PCAOB Quality Control Standards* (March Letter),[12] CII offers the following general comments in response to the Proposal. Following our general comments, we provide specific responses to select questions in the Proposal.

General Comments

In CII's September 2020 letter in response to the Request for Public Comment, *Draft 2022-2026 PCAOB Strategic Plan*,[13] we requested that the Board "prioritize its project on '"Quality Control'" (September Letter).[14] Our prioritization of the quality control (QC) project was based, in part, on our view that that improving audit quality necessarily requires firms to improve their QC mechanisms.[15]

We applaud the Board for prioritizing the QC project and we generally support the Board's efforts to provide a framework for the firms to perform high quality audits. At the same time, we are disappointed that the proposed framework fails to adequately incorporate CII recommendations derived from our membership approved policies. Those recommendations were set forth in the March Letter[16] and again summarized in the September Letter.[17] In order to

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[11] Letter from Jeffrey P. Mahoney, General Counsel, CII to Office of Secretary, PCAOB (Mar. 19, 2020), https://www.cii.org/files/issues_and_advocacy/correspondence/2020/March%2019%202020%20PCAOB%20Letter.pdf.

[12] Concept Release, Potential Approach to Revisions to PCAOB Quality Control Standards, PCAOB Release No. 2019-003 (Dec. 17, 2019), https://pcaobus.org/Rulemaking/Docket046/2019-003-Quality-Control-ConceptRelease.pdf.

[13] Request for Comment, Draft 2022-2026 PCAOB Strategic Plan, PCAOB Release No. 2022-003 (Aug. 16, 2022), https://pcaob-assets.azureedge.net/pcaob-dev/docs/defaultsource/about/administration/documents/strategic_plans/2022-003-rfc-draftstrategicplan.pdf?sfvrsn=fdc9859a_4; PCAOB, Strategic Plan, 2022-2026, Draft for Comment (Aug. 2022), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/about/administration/documents/strategic_plans/draft-2022-2026-strategic-plan.pdf?sfvrsn=65f830db_4/%20Draft-2022-2026-Strategic-Plan.pdf.

[14] Letter from Jeffrey P. Mahoney, General Counsel, CII to Office of the Secretary, PCAOB 5 (Sept. 15, 2022), https://www.cii.org/files/issues_and_advocacy/correspondence/2022/September%2015,%202022%20PCAOB%20letter%20(final).pdf.

[15] *Id.* (quoting Daniel L. Goelzer, a founding member of the PCAOB: '"In the long run, improving audit quality requires firms to improve their quality control mechanisms."').

[16] *See* Letter from Jeffrey P. Mahoney, General Counsel, CII to Office of Secretary, PCAOB at 3-8.

[17] *See id.* at 6 ("Moreover, as indicated in our March 2020 comment letter in response to the PCAOB's Concept Release, Potential Approach to Revisions to PCAOB Quality Control (QC) Standards, the Quality Control project supported by Mr. Goelzer has the potential of incorporating recommendations of the Department of the Treasury Advisory Committee on the Auditing Profession for improving audit quality including: • [Requiring] all of the largest audit firms . . . to have independent directors on their boards [whose duties include] . . . 'resource allocation decisions . . . the annual review of the QC system, the effectiveness of remediation of QC concerns, and the integration of audit quality into the system of incentives and rewards for firm personnel.'" • "[R]equir[ing] [firms] to establish quantifiable performance measures for the achievement of quality objectives", and • "[R]equir[ing] public disclosure by firms about their QC systems [including] . . . larger U.S. auditing firms be[ing] required to produce public annual reports that incorporate information about the firm's governance structure.").

correct these critical omissions in the Proposal, we respectfully request that the Board revise the Proposal to include, at a minimum, the following three items:

1. To require firms that issue auditor reports with respect to more than 100 issuers establish a QC committee of their board composed entirely of at least three persons independent of the firm and the firm publicly report at least annually meaningful information about how the QC committee carries out its responsibilities.
2. To require that the monitoring and remediation process provide for use of quantitative performance metrics.
3. To require public reporting regarding QC matters.

These three recommended revisions to the Proposal and other recommended improvements are discussed in more detail below in response to specific questions the Board has raised in the Proposal.

Specific Responses to Select Questions

10. Is the reasonable assurance objective described in the proposed standard appropriate? If not, why not? Are there additional objectives that a QC system should achieve? If so, what are they?[18]

CII generally views as appropriate the reasonable assurance objective described in paragraph .05 of the Proposed QC 1000.[19] We, however, believe that consistent with language in our policies on **Independence of Accounting and Auditing Standard Setters** and **Auditor Independence** paragraph .05 should be revised so that the underlying principles of the reasonable assurance objective explicitly include satisfying the information needs of the key customer of audited financial reports—investors—by ensuring high quality financial reporting.

More specifically, we would respectfully request that the Board consider the following proposed revision to paragraph .05a.(1):

.05 An effective QC system provides a firm with reasonable assurance that:

a. The firm*, firm personnel*, and *other participants*:

(1) Conduct engagements in accordance with *applicable professional and legal requirements* <u>and performed in a manner that is responsive to the needs of investors by ensuring high quality financial reporting</u>; and . . .

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[18] PCAOB Release No. 2022-006 at 67 (emphasis added).
[19] *See id.* at 58 ("05 an effective QC system provides a firm with reasonable assurance that: a. The firm, firm personnel, and other participants: (1) Conduct engagements in accordance with applicable professional and legal requirements; and (2) Fulfill their other responsibilities that are part of or subject to the firm's QC system in accordance with applicable professional and legal requirements; and b. Engagement reports issued by the firm are in accordance with applicable professional and legal requirements (hereinafter referred to as the 'reasonable assurance objective')").

The Proposal indicates the PCAOB considered but rejected similar approaches suggested by commentators[20] by finding that they "could create further uncertainty and inconsistency as firms attempt to satisfy the specific preferences of the users of the financial statements they audit."[21] We disagree.

Our proposed change to paragraph .05 is also generally consistent with the views of the Members of the Investor Advisory Group (MIAG) in response to the Proposal (MIAG Letter).[22] The MIAG Letter observed:

> 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.[23]

23. Is the proposed specified quality response to incorporate an oversight function for the audit practice for firms that issue auditor reports with respect to more than 100 issuers appropriate? If not, why not?[24]

CII does not believe the Proposal's specified quality response to incorporate an oversight function for the audit practice for firms that issue auditor reports with respect to more than 100 issuers is appropriate. As indicated in the March Letter, we "believe that all of the largest audit firms should be required to have independent directors on their boards" with oversight responsibilities for the QC system,[25] and those firms should be required to publicly report information about the determination of the independence of those directors as well as those activities relating to audit quality.[26]

We appreciate that Paragraph .28 of the Proposed QC 1000 takes a tentative step forward by requiring "at least one person in an oversight role who would be in a position to exercise

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[20] *See* PCAOB Release No. 2022-006 at 59-60 ("one investor advocate claimed that an objective based on compliance with requirements would set the bar too low compared to a standard like ISO 9001, one of whose underlying principles is that '[t]he primary focus of quality management is to meet customer requirements and strive to exceed customer expectations' [and] [a]nother comment letter suggested that the QC system should have an explicit goal that audits be performed in a manner that protects the interests of investors and broker-dealer customers and furthers the public interest.").
[21] *Id.* at 60.
[22] *See* Letter from Members of the Investor Advisory Group to the Office of the Secretary, Public Company Accounting Oversight Board 4 (Jan. 13, 2023), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket046/4_iag.pdf?sfvrsn=1941e7c0_4.
[23] *Id.*
[24] PCAOB Release No. 2022-006 at 101 (emphasis added).
[25] *See* Letter from Jeffrey P. Mahoney, General Counsel, CII to Office of Secretary, PCAOB at 4.
[26] *See id*. at 8 (Proposing required disclosure of "[h]ow a board member is determined to be independent of the firm • A discussion of all recommendations offered by the independent members that might impact audit quality and specific actions taken by the firm in response to those recommendations or an explanation why no action was taken").

independent judgment with regard to QC matters."[27] However, we believe the Proposal's approach is insufficient and stops far short of what CII and many investors have long contemplated as appropriate for at least two reasons[28]:

(1) The Proposal's approach essentially mandates a practice already in place for the largest firms and arguably does little, therefore, to require those firms to enhance the system of independent oversight beyond what is already being done; and[29]
(2) The Proposal's approach permitting as few as one person to serve in the oversight role makes it less likely that the approach will result in a meaningful oversight function for the audit practice.[30]

To address the inadequacies in the Proposal's approach, we would respectfully request that paragraph .28 of Proposed QC 1000 be revised as follows:

> .28 If the firm issued audit reports with respect to more than 100 issuers during the prior calendar year, the firm's governance structure should incorporate an oversight function for the audit practice that includes a designated QC board committee composed entirely of at least ~~one~~ three persons who ~~is~~ are not a partner, shareholder, member, other principal, or employee of the firm and do~~es~~ not otherwise have a commercial, familial, or other relationship with the firm that would interfere with the exercise of independent judgment with regard to matters related to the QC system. The firm should publicly report at least annually meaningful information about how the QC committee carries out its responsibilities, including: a copy of the QC committee charter and a statement by the committee that it has complied with the duties outlined in the charter; how the committee members were determined to be independent of the firm; and a discussion of all recommendations offered by the members of the QC committee that might

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[27] PCAOB Release No. 2022-006 at 97.
[28] *See, e.g.,* Transcript of Meeting of U.S. Dep't Treasury Advisory Committee on Auditing Prof. 215 (Feb. 4, 2007) (on file with CII) (Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System Dennis Johnson: " we think that the biggest improvements that could be made here are in the governance and transparency area [and] [we would support independent boards for audit firms . . . ."); Submission of Paul G Haaga Jr., Vice Chairman, Capital Research and Management Company to the Advisory Committee on the Auditing Profession 2 (Feb. 4, 2007) (on file with CII) ("In an effort to improve governance, we are strongly in favor of requiring an independent board at all auditing firms of public companies [and] . . . [o]versight would include . . . monitoring audit quality . . . .).
[29] *See id* at 98 n.163 ("In 2021, we observed the largest six firms had some form of governance structure that included a non-employee.").
[30] *Cf.* Jared Landaw, Barrington Capitol Group LP, Maximizing the Benefits of Board Diversity: Lessons Learned from Activist Investing, Harv. L. Sch. F. on Corp. Governance (July 14, 2020), https://corpgov.law.harvard.edu/2020/07/14/maximizing-the-benefits-of-board-diversity-lessons-learned-from-activist-investing/ ("one study found that a critical mass of at least three female directors is needed to change the dynamics on a board so that women are no longer viewed as outsiders and are able to have a substantive influence on board deliberations").

> impact audit quality and specific actions taken by the firm in response to those recommendations or an explanation why no action was taken.

As indicated, our recommended revisions are derived from our March Letter and our membership approved policies on **Audit Committee Responsibilities Regarding Independent Auditors**, **Auditor Independence,** and **The Board of Directors**. Those policies include provisions analogous to the SEC rules for corporate audit committees and the related New York Stock Exchange and Nasdaq Stock Market listing standards.[31]

We also believe our recommended revisions to paragraph .28 are aligned with the Proposal's related findings that: (1) "Firm governance . . . establish[es] the environment that determines how firm personnel carry out responsibilities for the operation of a firm's QC system and the performance of its engagements[;]"[32] (2) "Such an oversight function could reduce negative impacts of commercial considerations on decision making by firms about their QC system and thereby improve incentives to implement QC systems that more fully meet the interests of investors and financial statement users"[;][and] (3) "Some academic research finds that the level of Board independence is associated with benefits."[33]

In addition, we would not object to revising the paragraph .28 threshold from "[i]f the firm issued audit reports with respect to more than 100 issuers during the prior calendar year" to a threshold based on market capitalization of the firms audited. On this point we generally agree with following observation contained in MIAG Letter:

> [W]e 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

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[31] *See* Listing Standards Relating to Audit Committees, 17 C.F.R § 240.10A-3(b)(1)(i) (last amended Jan. 4, 2008), *available at* https://www.law.cornell.edu/cfr/text/17/240.10A-3 ("Each member of the audit committee must be a member of the board of directors of the listed issuer, and must otherwise be independent; provided that, where a listed issuer is one of two dual holding companies, those companies may designate one audit committee for both companies so long as each member of the audit committee is a member of the board of directors of at least one of such dual holding companies.");NYSE Listed Company Manual, Section 303A Corporate Governance Standards, Frequently Asked Questions 1 (revised July 28, 2021), https://www.nyse.com/publicdocs/nyse/regulation/nyse/FAQ_NYSE_Listed_Company_Manual_Section_303A_7_28_2021.pdf (requiring "a fully independent audit committee within one year of the effective date of its registration statement (Section 303A.06) . . . [and] and at least three members on its audit committee within one year of the listing date (if Section 303A.07(a) is applicable); Nasdaq Stock Market, Listing Center, Rulebook, § 5605(c)(2)(A) (amended Jan. 11, 2013), https://listingcenter.nasdaq.com/rulebook/nasdaq/rules/nasdaq-5600-series ("Each Company must have, and certify that it has and will continue to have, an audit committee of at least three members, each of whom must: (i) be an Independent Director as defined under Rule 5605(a)(2); (ii) meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Act (subject to the exemptions provided in Rule 10A-3(c) under the Act); (iii) not have participated in the preparation of the financial statements of the Company or any current subsidiary of the Company at any time during the past three years; and (iv) be able to read and understand fundamental financial statements, including a Company's balance sheet, income statement, and cash flow statement.").

[32] PCAOB Release No. 2022-006 at 202.

[33] *Id.* at 274-75.

> 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.[34]

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?[35]

CII generally believes that firms should be required to adopt firm-wide codes of ethics and mechanisms, including an annual written certification regarding familiarity and compliance. Our view is generally consistent with our membership approved policies which state: "The Council believes *every* company should have written, disclosed governance procedures and policies, an ethics code that applies to all employees and directors, and provisions for its strict enforcement."[36]

Our view is also generally consistent with the view of the MIAG.[37] The MIAG Letter recommendation states:

> 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[s] requirements.[38]

36. Are the proposed quality objectives for resources appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?[39]

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[34] Letter from Members of the Investor Advisory Group to the Office of the Secretary, Public Company Accounting Oversight Board at 6; *cf.* Letter from Robert A. Conway, CPA in Response to the PCAOB's Proposed System of Quality Controls 12 (Jan. 4, 2023), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket046/3_conway.pdf?sfvrsn=cec2a71e_6.
[35] PCAOB Release No. 2022-006 at 119 (emphasis added).
[36] CII, Policies on Corporate Governance § 1.3 Disclosed Governance Policies and Ethics Code (emphasis added).
[37] *See* Letter from Members of the Investor Advisory Group to the Office of the Secretary, Public Company Accounting Oversight Board at 6.
[38] *Id.; see* PCAOB Release No. 2022-006 at 106 ("One commenter recommended that an annual written acknowledgment be obtained from relevant personnel regarding their compliance with certain fundamental ethics requirements, including, among other things, the integrity and objectivity concepts in QC 20 and client confidentiality.").
[39] PCAOB Release No. 2022-006 at 136 (emphasis added).

CII generally believes the proposed quality objectives for resources are appropriate. We, however, respectfully request that, consistent with the March Letter and CII membership approved policies, the following two revisions to paragraph .44 of Proposed QC 1000 be considered:

Paragraph .44a.[40]

We believe paragraph .44a. of Proposed QC 1000 should be revised as follows:

> .44 The quality objectives established by the firm with respect to the firm's resources should include the following:
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> a. *Firm personnel* are hired, developed, and retained who have the competence to perform activities and carry out responsibilities for the operation of the firm's QC system and the performance of the firm's *engagements* in accordance with *applicable professional and legal* requirements and the firm's policies and procedures.
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> > Note*:* Competence consists of having the knowledge, skill, and ability to enable individuals to act in accordance with *applicable professional and legal requirements* and the firm's policies and procedures. ~~The measure of competence is qualitative rather than quantitative because quantitative measurement may not accurately reflect the experience gained by *firm personnel* over time~~.

We believe striking the last sentence of the Note to paragraph .44a. is necessary because the language would otherwise appear to prohibit or discourage the use of quantitative performance metrics in measuring the competence of firm personnel. As indicated in the March Letter, we believe firm's "should be required to establish quantifiable performance measures for the achievement of quality objectives."[41] And with respect to .44a., we believe qualitative measures of competence should be supplemented by quantitative measurements.[42]

Paragraph .44g.[43]

We also believe paragraph .44g. of Proposed QC 1000 should be revised as follows:

> g. Firm personnel are (1) evaluated at least annually, (2) incentivized to fulfill their assigned responsibilities and adhere to appropriate standards of conduct, including compensated in a manner that weights revenue

[40] *Id.* at 133.
[41] Letter from Jeffrey P. Mahoney, General Counsel, CII to Office of Secretary, PCAOB at 4.
[42] *Cf.* Letter from Robert A. Conway, CPA in Response to the PCAOB's Proposed System of Quality Controls at 10-11 ("It seems to preclude the use of metrics that could be instrumental in any monitoring activity over the deployment of human resources in audit operations [and][i]f a new quality control standard is somehow limited to qualitative aspects of competence, I fear that the PCAOB will have merely paved the cow path with no benefit to investors.").
[43] PCAOB Release No. 2022-006 at 136.

> generation less heavily than professional competencies, and (3) held accountable for their actions and failures to act.

CII membership approved policies reflect the view that executive compensation is a critical element of good corporate governance.[44] And our proposed change to paragraph .44g. is generally consistent with that policy and views of the MIAG.[45] The MIAG Letter explained:

> We note one very 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.[46]

Our proposed change to paragraph .44g. also appears to be supported by the research referenced by the Board and PCAOB Chair Erica Williams. More specifically, the Proposal states:

> [E]xperimental research suggests that certain cognitive biases in auditor evaluation and reward systems may inadvertently deter appropriate professional skepticism and other studies suggest that partner reward systems at some firms may weight revenue generation more heavily than professional competencies. Some research finds that reward systems oriented toward revenue generation are associated with lower proxies for audit quality.[47]

And similarly in commenting on the Proposal, Chair Williams emphasized that "studies have found that some firms' partner-reward systems may prioritize revenue generation over professional competency."[48]

45. Are the proposed requirements for the monitoring and remediation process appropriate? Are changes to the requirements necessary for this process? If so, what changes should be made and why?[49]

CII generally believes the proposed requirements for the monitoring and remediation process are appropriate. However, as indicated in our previous response to Question 36, we would respectfully recommend that the proposed requirements be changed to provide, at a minimum, that the monitoring and remediation process make use of performance metrics at the engagement

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[44] *See* Council of Institutional Investors, Policies on Corporate Governance § 5 Executive Compensation.
[45] *See* Letter from Members of the Investor Advisory Group to the Office of the Secretary, Public Company Accounting Oversight Board at 4.
[46] *Id.*
[47] PCAOB Release No. 2022-006 at 260 (footnotes omitted).
[48] News Release, Chair Williams: PCAOB Quality Control Proposal Will Better Protect Investors (Nov. 29, 2022), https://pcaobus.org/news-events/news-releases/news-release-detail/chair-williams-pcaob-quality-control-proposal-will-better-protect-investors.
[49] PCAOB Release No. 2022-006 at 198 (emphasis added).

level. Moreover, as also indicated in the March Letter, we would also respectfully request that those performance metrics should, at a minimum, include (1) a "workload" measure; and (2) an "experience" measure.[50] It is our expectation that additional measures will be added following the completion of the Board's current project entitled "Firm and Engagement Performance Metrics."[51]

We note that our proposed recommendation is generally consistent with the views and recommendations of other commentators and investors including the MIAG.[52] The MIAG Letter stated:

> 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. . . . . 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.
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> To that end, we recommend a minimum requirement of eight indicators as part of the quality control standard.[53]

We note that the MIAG recommends eight performance metrics compared to our proposed two. And that four of the eight metrics proposed by the MIAG focus on workload or experience metrics consistent with our recommendation in the March Letter.

We also note that the Board acknowledges in the Proposal that (1) "research finds that a heavier workload in the fieldwork phase of the audit is negatively associated with proxies for audit quality and that high levels of time pressure are positively associated with audit quality threatening behaviors";[54] and (2) the "experience . . . of engagement partners . . . could impact

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[50] *See* Letter from Jeffrey P. Mahoney, General Counsel, CII to Office of Secretary, PCAOB at 4.
[51] *See* PCAOB, Standard Setting and Research Projects (last visited Jan. 19, 2023), https://pcaobus.org/oversight/standards/standard-setting-research-projects.
[52] *See* Letter from Members of the Investor Advisory Group to the Office of the Secretary, Public Company Accounting Oversight Board at 4; *see also* PCAOB Release No. 2022-006 at 174-75 ("Several commenters, including investor groups, expressed support for a standard that would require firms to use performance measures as part of their monitoring activities [and] . . . [s]ome commenters, including investor groups, suggested requiring firms to use certain metrics that they believed were the most indicative of audit quality, and some recommended measurements related to workload and experience of engagement team personnel."); *cf.* Letter from Robert A. Conway, CPA in Response to the PCAOB's Proposed System of Quality Controls at 12 ("the monitoring and remediation process should be prescriptive at the engagement level and should make use of basic engagement performance metrics [and suggesting 5 metrics including: a] "Staff and Manager Workload Metric . . . [a] Partner Workload/Capacity . . . [an] Engagement Team Continuity Metric . . . [and an] Experience Metric . . . .").
[53] Letter from Members of the Investor Advisory Group to the Office of the Secretary, Public Company Accounting Oversight Board at 4.
[54] PCAOB Release No. 2022-006 at 261.

the risks of noncompliance with applicable professional and legal requirements associated with an engagement, either positively or negatively."[55]

More broadly we note the Board also acknowledges in the Proposal that the use of performance metrics "would enhance [some firms'] ability to identify deficiencies, measure whether quality objectives have been met, and evaluate the effectiveness of remediation activities.[56]

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?[57]

As indicated in the March Letter, CII supports public reporting regarding QC matters.[58] We agree with the criticism expressed by the MIAG that "information about the quality of audits and auditors is available to the Board, but remains unavailable to investors in this proposal."[59] Similarly, we agree with the following views of commentators referenced in the Proposal:

> [I]nvestors and investor advocates, were supportive of the PCAOB requiring some level of public reporting about firms' QC systems. . . . "[T]hat such U.S. reporting would be similar to audit quality reports required by certain jurisdictions, such as reports required by the European statutory audit regulations. Some commenters highlighted the benefits of public reporting, including increased transparency and accountability. . . . [And] . . . that investors would particularly benefit from public reporting and one commenter cited improving investor confidence.[60]

Those views should not be surprising to the Board since similar views were expressed by investors beginning in 2008 in connection with input received by the U.S. Department of the Treasury Advisory Committee on the Auditing Profession (ACAP).[61]

Unfortunately, the Proposal rejects the view of CII and many investors by not requiring any meaningful disclosure about the system of QC to investors. As a result, investors will not know whether firms have developed a feedback loop sufficient to proactively identify deficiencies before they appear in PCAOB inspections. Nor will investors be aware of the resources devoted to the system, the persons responsible for overseeing audit quality, or the firm's own conclusion about the effectiveness of the system.

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[55] *Id.* at 170.
[56] *Id.* at 175.
[57] *Id.* at 219 (emphasis added).
[58] Letter from Jeffrey P. Mahoney, General Counsel, CII to Office of Secretary, PCAOB at 6 ("We believe a future PCAOB QC standard should require public disclosure by firms about their QC systems.").
[59] Letter from Members of the Investor Advisory Group to the Office of the Secretary, Public Company Accounting Oversight Board at 2.
[60] PCAOB Release No. 2022-006 at 211.
[61] *See* Advisory Committee on the Auditing Profession, Final Report, Dep't Treasury VII:22 n.91 (Oct. 6, 2008) (on file with CII) ("Written Submission of Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management . . . recommending auditing firm disclosure of quality control policies and procedures").

In justifying the proposed non-disclosure of QC matters to the public, the Proposal largely pointed to the presence of information subject to mandatory obligations of confidentiality under the Sarbanes Oxley Act of 2002 (SOX).[62] More specifically, Section 104 of SOX prohibits the PCAOB from disclosing the "portions of the inspection report" that included "criticisms of or potential defects in the quality control systems" unless not remediated within 12 months. [63] To the extent that the QC Form called for the inclusion of PCAOB identified deficiencies in quality control, disclosure, according to the Proposal, could violate this provision of SOX.

Whatever the merits of the argument about the impact of the SOX provision on the public issuance of the QC Form, as indicated, we believe the QC Form should, at a minimum, be made public with the PCAOB identified deficiencies redacted. The Proposal noted this possibility but determined that such disclosure: (1) would provide an "incomplete, potentially confusing, and potentially misleading picture of the effectiveness of the firm's QC system"; and (2) "would [not] be in the interests of investors or other stakeholders . . . ."[64] We strongly disagree with that determination for a number of reasons, including the following:

- We believe there is plenty of information in the QC Form that would be beneficial to investors for investment or proxy voting decisions even if all information about deficiencies was omitted;
- We observe the Proposal purports to "be in the interest of investors" by denying them information they have asked for and cites no basis in support for that point of view;[65]
- We believe the logic of the Proposal's approach is circular: It creates a QC Form, includes information subject to mandatory confidentiality obligations, then uses those obligations to justify non-disclosure to investors;
- We believe the Proposal's approach appears inconsistent with the practice of the PCAOB in other areas, including inspection reports which specifically acknowledge the incompleteness of the information and caution against excessive reliance; and[66]

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[62] *See* Sarbanes Oxley Act of 2002, tit.1, §104(g)(2) (July 30, 2002), https://www.congress.gov/107/plaws/publ204/PLAW-107publ204.pdf ("(g) REPORT.—A written report of the findings of the Board for each inspection under this section, subject to subsection (h), shall be—. . . (2) made available in appropriate detail to the public (subject to section 105(b)(5)(A), and to the protection of such confidential and proprietary information as the Board may determine to be appropriate, or as may be required by law), except that no portions of the inspection report that deal with criticisms of or potential defects in the quality control systems of the firm under inspection shall be made public if those criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report.").
[63] *Id.*
[64] PCAOB Release No. 2022-006 at 213 ("We do not believe that making incomplete, potentially confusing, and potentially misleading Form QCs public would be in the interests of investors or other stakeholders, who depend on the accuracy and completeness of such information to guide their decision-making."); *but see id.* at 214 ("soliciting comment on whether, in lieu of proposed Form QC, reporting on the evaluation of the QC system should be done through a non-public portion of the annual report on Form 2.").
[65] *Id.* at 213.
[66] *See, e.g.,* 2021 Inspection, Mazars USA LLP, PCAOB 2 (Sept, 15, 2022), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/inspections/reports/documents/104-2022-201-mazarsusa.pdf?sfvrsn=e113ff07_4 ("Our selection of audits for review does not necessarily constitute a

- We believe the overall benefits of the Proposal would be reduced without public issuance of the QC Form to investors because, in part, the PCAOB would already be aware of deficiencies in the firm's QC systems and of related firm remediation efforts prior to the release of the Form QC.

In our view, public disclosure of incomplete information to investors about the firms' QC systems is superior to no disclosure of information.

79. Are the proposed amendments to other PCAOB standards and rules appropriate? If not, why not? Are there additional amendments to other PCAOB standards or rules that the Board should consider?[67]

CII generally believes that the proposed amendments to the PCAOB standards and rules are appropriate. We are particularly supportive of the (1) proposed amendments to AS 1301, *Communications with Audit Committees* (AS 1301),[68] and (2) proposed new Standard AS 1310, *Notification of Termination of the Auditor-Client Relationship* (AS 1310).[69]

<u>Proposed amendments to AS 1301</u>

We believe the proposed amendments to AS 1301 would result in firm reporting to the audit committee generally consistent with the provisions of **Audit Committee Responsibilities Regarding Independent Auditors**. As indicated, those provisions provide for audit committee consideration of the "quality and frequency of communication from the auditor to the audit committee" and "inspection results."

We acknowledge that given the risks of PCAOB enforcement in the event of a QC failure, the audit committee disclosure resulting from the proposed amendments to AS 1301 might not provide much incremental incentive for firms to avoid or remediate deficiencies so that clients do not have to be informed of them. We also acknowledge that while it would be natural for audit committees to ask about the potential impact of any deficiencies on their audit, the proposed disclosure of known deficiencies might not have any practical consequences for some specific audits. That said, we agree with the Board that the proposed amendments to AS 1301 could provide the following benefits:

- "[E]nhance audit committee oversight by providing potentially valuable information about the firm and greater context and insight into the audit process",[70]

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representative sample of the firm's total population of issuer audits [and] [a]dditionally, our inspection findings are specific to the particular portions of the issuer audits reviewed [and] [t]hey are not an assessment of all of the firm's audit work nor of all of the audit procedures performed for the audits reviewed.").

[67] PCAOB Release No. 2022-006 at 244 (emphasis added).

[68] *Id.* at 242.

[69] *Id.* at 243.

[70] *Id.* at 242.

- "[R]elevant to the audit committee's responsibilities in connection with . . . appointment and retention",[71] and
- "Promote beneficial dialogue between the audit committee about QC matters."[72]

Proposed AS 1310 `

As indicated, we generally support proposed AS 1310. We believe it is complementary to the provisions of **Disclosure of Reasons Behind Auditor Changes**. We also believe the proposed AS 1310 is generally consistent with investor input to the ACAP.[73]

We agree with the Board that proposed AS 1310 should "apply to all issuer engagements, regardless of whether the firm was a member of the [Securities & Exchange Commission Practice Section] SECPS and regardless of whether the issuer is required to report on Form 8-K."[74] We also agree with the Board that "such notice could provide valuable information to the SEC."[75] And we believe it could also provide valuable and timely information to investors to alert them to circumstances when audit committees have failed to fulfill their reporting responsibilities.

84. Should we consider any additional academic studies or data related to the need for standard setting?[76]

The Proposal makes multiple references to firm or engagement level performance metrics as a potentially important element of a QC system. As indicated in response to Question 45 we believe the Proposal's provisions should be changed to provide, at a minimum, that the monitoring and remediation process make use of performance metrics at the engagement level.

More broadly, we agree with the MIAG that requiring performance measures at the engagement, firm and *office level* could provide useful information to investors in making investment or proxy voting decisions.[77] And with respect to office level performance metrics, we note that an academic study recently published in the *Journal of Accounting and Public Policy,* but not

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[71] *Id.; cf.* Letter from John Paul, Chair, Financial Reporting Committee, Institute of Management Accountants to Office of the Secretary, PCAOB 4 (Jan. 3, 2023), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket046/2_ima-frc.pdf?sfvrsn=287d6a27_4 ("Receiving this oral confirmation of what has been reported to the PCAOB on Form QC will be an important part of the audit committee's annual assessment of the independent auditor relationship.").
[72] PCAOB Release No. 2022-006 at 243.
[73] *See* Advisory Committee on the Auditing Profession, Final Report, Dep't Treasury at VII:14 n.47 ("Written Submission of Paul G. Haaga Jr., Vice Chairman, Capital Research and Management Company . . . calling for public disclosure on audit partner changes other than for rotation requirements").
[74] PCAOB Release No. 2022-006 at 243.
[75] *Id.*
[76] *Id.* at 268 (emphasis added).
[77] *See* Letter from Members of the IAG to Office of Secretary, Public Company Accounting Oversight Board 3 (Sept. 15, 2022), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/about/administration/strategic-plan-comments-2022/10_iag.pdf?sfvrsn=f24d0e63_4 ("We suggest another way to deliver guidance to the audit profession that would be useful, objective, and unbiased: the development and establishment of audit quality indicators (AQI), at the audited company level, audit firm office level, and the audit firm level.").

referenced in the Proposal, lends support for our view that some performance metrics should be required at the office level as well as the firm and engagement levels.[78]

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We appreciate the opportunity to provide CII's investor-focused perspective on the Proposal. Please let me know if you have any questions about the contents of this letter.

Sincerely,

Jeffrey P. Mahoney
General Counsel

[78] Albert L.Nagy, Matthew G. Sherwood & Aleksandra B. Zimmerman, CPAs and Big 4 office audit quality, J. Acct. & Pub. Policy 4 (Sept. 10, 2022*), available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2965292 ("Overall, our results suggest that audit offices with more qualified human capital are associated with higher quality audits"); *see* CPAs and Big 4 Office Audit Quality with Albert Nagy, Voice of Corp. Governance (Dec. 20, 2022), https://podcasts.apple.com/us/podcast/cpas-and-big-4-office-audit-quality-with-albert-nagy/id1433954314?i=1000590770769 (Responding to question: "Based on your research, do you have any advice on how the PCAOB might move this critically important project forward in a manner that benefits investors?").