

Via Email

March 19, 2020

Office of Secretary
PCAOB
1616 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket No. 046: Concept Release, Potential Approach to Revisions to PCAOB Quality Control Standards¹

Dear Office of the Secretary:

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) Concept Release, *Potential Approach to Revisions to PCAOB Quality Control (QC) Standards* (Release).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 reflected in the following CII membership-approved policy on the “Independence of Accounting and Auditing Standard Setters”:

¹ 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-Concept-Release.pdf>.

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.

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 includes the following additional provisions that we believe may be 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:

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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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- 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
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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.

....

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.⁸

⁵ *Id.*

⁶ *Id.*

⁷ CII, Policies on Corporate Governance § 2.13 Auditor Independence (last updated Oct. 24, 2018), https://www.cii.org/corp_gov_policies.

⁸ *Id.*

In furtherance of the language and intent of our membership approved policies, CII offers the following comments in response to select questions contained in the Release.

IV. A. Firm Governance and Leadership:⁹

17. *Should a future PCAOB QC standard incorporate mechanisms for independent oversight over firms' systems (e.g., boards with independent director or equivalent)? If so, what criteria should be used to determine whether and which firms should have such independent oversight (e.g., firm size or structure)? What requirements should we consider regarding the qualifications and duties of those providing independent oversight?*¹⁰

We believe that a future PCAOB QC standard should incorporate the recommendation of the U.S. Department of Treasury Advisory Committee on the Auditing Profession (ACAP) that audit firms' boards have "**independent members with full voting power to firm boards . . .**"¹¹ In support of the recommendation, the ACAP referenced, among other supporting witnesses, Paul G. Haaga Jr., then Vice Chairman, Capital Research and Management Company.¹² Mr. Haaga "called for an entirely independent board with enhanced responsibilities, including . . . monitoring potential conflicts of interest and *audit quality*."¹³ The ACAP ultimately concluded that "independent board members could improve investor protection through enhanced *audit quality* and firm transparency."¹⁴

Given the importance of independent oversight to audit quality, we believe audit firms should be required to have independent oversight of their systems. It is our understanding that currently two of the largest audit firms have independent directors on their boards.¹⁵

⁹ PCAOB Release No. 2019-003 at 14-17.

¹⁰ *Id.* at 16.

¹¹ The Department of the Treasury, Advisory Committee on the Auditing Profession, Final Report VII:8 (Oct. 6, 2008), <https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>; see Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to Brent J. Fields, Secretary, Securities and Exchange Commission 5 (June 28, 2018), [https://www.cii.org/files/June%2028%202018%20letter%20to%20SEC%20\(finalJPM\).pdf](https://www.cii.org/files/June%2028%202018%20letter%20to%20SEC%20(finalJPM).pdf) ("A good starting point for improving audit firm governance would be to consider requiring the implementation of the governance recommendations contained in the 2008 Final Report of The Department of the Treasury Advisory Committee on the Auditing Profession").

¹² The Department of the Treasury, Advisory Committee on the Auditing Profession, Final Report VII:9-10 & n.35.

¹³ *Id.* (emphasis added).

¹⁴ *Id.* at VII:10 (emphasis added).

¹⁵ J. Robert Brown, Board Member, PCAOB, Statement on Concept Release for Potential Approach to Revisions to PCAOB Quality Control Standards: The Role of Investors and the Public in the Revisions to PCAOB Quality Control Standards (Dec. 17, 2019), <https://pcaobus.org/News/Speech/Pages/Brown-statement-concept-release-potential-approach-PCAOB-quality-control-standards.aspx> ("two of the largest audit firms have added independent directors to their boards [and] [a]t least three others use advisory groups with independent members [and] [a] number of countries have adopted rules that require audit firms to have independent directors.").

We believe that all of the largest audit firms should be required to have independent directors on their boards.¹⁶ We believe the benefits of requiring independent directors on firm boards would exceed the costs of imposing such a change at the largest audit firms.

In addition, we believe the duties of those providing independent oversight should include, among other responsibilities, “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.”¹⁷

IV. B. The Firm’s Risk Assessment Process:¹⁸

21. *Should firms be required to establish quantifiable performance measures for the achievement of quality objectives? If so, how should such measures be determined and quantified (see also Question 46)?¹⁹*

We believe firms should be required to establish quantifiable performance measures for the achievement of quality objectives. As we indicated in 2015 in response to the PCAOB’s concept release on audit quality indicators (AQI’s)²⁰ (2015 Letter):

Generally consistent with our policies, CII strongly supports the . . . [PCAOB’s] efforts to implement the recommendation of the [ACAP] . . . to develop “key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose those . . . [AQI’s].”

. . . .

CII generally believes that a “portfolio of properly chosen AQI’s” of engagement-level and firm-level data would be useful to investors. 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.²¹

We also believe that, at a minimum, two performance measures for the achievement of quality objectives should be required: (1) a “workload” measure;²² and (2) an “experience” measure.²³

¹⁶ For purposes of this letter, we define the “largest audit firms” as the twelve audit firms that provide audit reports for more than 100 issuers and are therefore annually inspected by the PCAOB. *See* PCAOB, Inspected Firms (last visited Mar. 19, 2020), <https://pcaobus.org/Inspections/Pages/InspectedFirms.aspx>.

¹⁷ J. Robert Brown, Board Member, PCAOB, Statement on Concept Release for Potential Approach to Revisions to PCAOB Quality Control Standards: The Role of Investors and the Public in the Revisions to PCAOB Quality Control Standards.

¹⁸ PCAOB Release No. 2019-003 at 17-19.

¹⁹ *Id.* at 18.

²⁰ *Concept Release on Audit Quality Indicators, Notice of Roundtable*, PCAOB Release No. 2015-005 (July 1, 2015), https://pcaobus.org/Rulemaking/Docket%20041/Release_2015_005.pdf.

²¹ Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Phoebe W. Brown, Office of the Secretary, Public Company Accounting Oversight Board 4, 5 (Sept. 17, 2015) (footnotes omitted), https://www.cii.org/files/issues_and_advocacy/correspondence/2015/09_17_15_PCAOB_letter.pdf.

²² *Id.* at 7.

²³ *Id.* at 8.

Workload Measure

As described in the 2015 Letter, the potential benefits of a workload measure to the achievement of quality objectives was recognized by the ACAP in the development of its recommendation in support of AQI's.²⁴ In addition, in 2014,²⁵ and as recently as last year, the Center for Audit Quality (CAQ) indicated workload measures were "important to audit quality."²⁶ Moreover, the linkage between a workload measure and audit quality is supported by academic research indicating that concerns can arise when senior managers work long hours.²⁷

Generally consistent with the view of CAQ²⁸ and the recent comment letter of Robert A. Conway,²⁹ we believe an appropriate determination and quantification of a workload measure for the achievement of quality objectives could be the amount of hours incurred over 40 hours per week as a percentage of total hours incurred for partners and each level of the engagement team staff.

Experience Measure

As described in the 2015 Letter, the potential benefits of an experience measure to the achievement of quality objectives was also recognized by the ACAP in the development of its recommendation in support of AQI's.³⁰ Similarly, in 2014,³¹ and again last year, the CAQ

²⁴ See The Department of the Treasury, Advisory Committee on the Auditing Profession, Final Report at VIII:16 n.56 ("Anonymous Retired Big 4 partner . . . , recommending public disclosure of the following audit quality drivers: . . . professional chargeable hours managed . . .").

²⁵ See Center for Audit Quality, CAQ Approach to Audit Quality Indicators 11 (Apr. 2014), <https://www.thecaq.org/wp-content/uploads/2019/03/caq-approach-to-audit-quality-indicators-april-2014.pdf> ("A workload AQI may, therefore, be a good indicator of partner(s)' and manager(s)' capacity to effectively supervise the audit, review the work of subordinates, and execute audit procedures.")

²⁶ See Center for Audit Quality, Audit Quality Disclosure Framework 12 (Jan. 2019), https://www.thecaq.org/wp-content/uploads/2019/03/caq_audit_quality_disclosure_framework_2019-01.pdf ("assigning resources with the relevant knowledge and experience to engagement teams based on company risk profiles while managing . . . workload is important to audit quality").

²⁷ See Brant E. Christensen et al., *How Do Audit Team Workloads and Audit Team Staffing Affect Audit Outcomes? Archival Evidence from U.S. Audits* 4 (July 2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3418533 ("Overall, our results provide evidence that teams with higher total workloads during fieldwork deliver lower quality audits than other teams, supporting the concerns of regulators and practitioners").

²⁸ Center for Audit Quality, Audit Quality Disclosure Framework at 18 ("Average hours worked in excess of standard workweek by staff level").

²⁹ See Letter by Robert A. Conway, CPA to PCAOB 18 (Jan. 15, 2020), https://pcaobus.org/Rulemaking/Docket046/003_%20R-Conway.pdf ("Percentage of hours incurred over 40 hours per week as a percentage of total hours incurred"). We note that Mr. Conway indicates that he "was widely credited with providing the impetus for ACAP's final report recommendation that the PCAOB evaluate the feasibility and potential benefits of providing public transparency to audit firm input and output measures that may be indicators of audit quality." *Id.* at 3.

³⁰ See The Department of the Treasury, Advisory Committee on the Auditing Profession, Final Report at VIII:16 n.56 ("Anonymous Retired Big 4 partner . . . recommending public disclosure of the following audit quality drivers: . . . average years of experience of audit professionals . . .").

³¹ See Center for Audit Quality, CAQ Approach to Audit Quality Indicators at 8 ("The collective knowledge and experience of the engagement team is important for achieving audit quality.").

indicated experience measures were “important to audit quality.”³² Moreover, academic research indicates the experience of members of the engagement team can affect audit quality.³³

Generally consistent with the view of CAQ,³⁴ and the recent comment letter of Robert A. Conway,³⁵ we believe an appropriate determination and quantification of an experience measure for the achievement of quality objectives could be the average number of years of professional experience for the partners and each level of the engagement team staff. That metric could be supplemented by a qualitative disclosure describing the extent of experience for the partners and each member of the engagement team staff on audits of companies of similar size, industry, or complexity.

IV. G. Information and Communication:³⁶

39. *Should a future PCAOB QC standard require public disclosure by firms about their QC systems? If so, what should be the nature and timing of such disclosures (e.g., information about the firm’s governance structure)? (see also Question 46)*³⁷

We believe a future PCAOB QC standard should require public disclosure by firms about their QC systems. We note that the ACAP recommended requiring larger auditing firms to produce public annual reports.³⁸ The basis for the ACAP recommendation references a number of witnesses and commentators including James D. Cox, Duke University, and Lawrence A. Cunningham, George Washington University who expressed support for “financial statement disclosure for assessing *audit quality* and independence.³⁹ The ACAP ultimately found that such reports “*could improve audit quality* by enhancing the transparency of auditing firms and note[d] that some foreign affiliates of U.S. auditing firms provide such indicators in public reports issued in other jurisdictions.”⁴⁰

³² *Id.* at 12.

³³ See Daniel Aobdia et al., *The Economics of Audit Production: What Matters for Audit Quality?* (July 24, 2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3300277 (“Evaluating client-specific expertise, we find that increased client expertise is associated with better audit quality. These results are driven by the other experienced team members. . .”).

³⁴ Center for Audit Quality, *Audit Quality Disclosure Framework* at 18 (“Average number of years in the profession by staff level”).

³⁵ See Letter by Robert A. Conway, CPA to PCAOB at 18 (“Years of Experience subsequent to CPA Licensing”).

³⁶ PCAOB Release No. 2019-003 at 32-33.

³⁷ *Id.* at 33.

³⁸ The Department of the Treasury, Advisory Committee on the Auditing Profession, Final Report at VII:20 (“**Recommendation 7. Urge the PCAOB to require that, beginning in 2010, larger auditing firms produce a public annual report incorporating (a) information required by the EU’s Eighth Directive, Article 40 Transparency Report deemed appropriate by the PCAOB, and (b) such key indicators of audit quality and effectiveness as determined by the PCAOB in accordance with Recommendation 3 in Chapter VIII of this Report. Further, urge the PCAOB to require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements**”).

³⁹ *Id.* at VII:22 n.93 (emphasis added).

⁴⁰ *Id.* at VII:21-22 (emphasis added).

In December 2017 then PCAOB Board Member Steven B. Harris called for regulators to adopt the audit firm governance recommendations contained in the ACAP Report.⁴¹ Mr. Harris explained:

At this year's [PCAOB Investor Advisory Group] IAG meeting, members recommended by unanimous consent that the Big Four provide annual audited financial statements. . . . Regulators could use such information to evaluate the risks that different business lines pose to one another or *anticipate and mitigate challenges to a firm's ability to conduct high quality audits.*⁴²

In March 2018, then Securities and Exchange Commission (SEC) Chief Accountant Wesley Bricker discussed audit firm governance in remarks at the 2018 Baruch College Financial Reporting Conference.⁴³ Mr. Bricker discussed how audit quality reports should include: “meaningful information about the design of an audit firm’s governance and culture, including the design of the firm’s board, its membership, the particular responsibilities assigned to the members, why a member of a board . . . is determined to be “independent” of the firm, and related information that would inform an audit committee’s consideration of the audit firm’s commitment to factors that *impact audit quality.*”⁴⁴

In light of the above recommendations and other input we have received from leading members of the auditing profession and investor community, in 2018 in response to the SEC’s proposed rule on *Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationship*,⁴⁵ we recommended that the larger U.S. auditing firms be required to produce public annual reports that incorporate information about the firm’s governance structure.⁴⁶ Our 2018 recommendation outlining the proposed requirements is set forth below with minor modifications, including the addition of the AQI’s referenced in our response to question 21 above.

Outline of Content and Nature of CII Recommended Larger Audit Firm Annual Report

- Audited financial statements of the firm prepared in accordance with U.S. generally accepted accounting principles
- An audit quality report of the firm including, at a minimum:

⁴¹ Steven B. Harris, Board Member, PCAOB, Speech at the 2017 International Institute on Audit Regulation (Dec. 7, 2017), <https://pcaobus.org/News/Speech/Pages/Harris-Audit-Industry-Concentration-12-07-17.aspx>.

⁴² *Id.* (emphasis added).

⁴³ Wesley Bricker, Chief Accountant, SEC, Remarks before the 2018 Baruch College Financial Reporting Conference: Working Together to Advance Financial Reporting (May 3, 2018), <https://www.sec.gov/news/speech/speech-bricker-040318>.

⁴⁴ *Id.* (emphasis added).

⁴⁵ *Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*, Securities Act Release No. 10,491, Exchange Act Release No. 83,157, Investment Company Act Release No. 33,091, Investment Advisor Act Release No. 4,904, 83 Fed. Reg. 20,753 (proposed May 8, 2018), <https://www.govinfo.gov/content/pkg/FR-2018-05-08/pdf/2018-09721.pdf>.

⁴⁶ See Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to Brent J. Fields, Secretary, Securities and Exchange Commission at 9-10.

- A qualitative discussion of:
 - How they define the U.S. firm and its relationship with foreign affiliates
 - How the firm performs individual audits
 - How they run the business
 - How they think about the role and relevance of the auditing profession
 - How they train audit personnel, including:
 - How they ensure that all audit professionals understand and appreciate that the investing public is the auditor's primary client
 - How they compensate and incentivize audit professionals
 - How they invest in new and enhanced audit technologies
 - How they have designed the firm's governance and structure, including
 - Board membership
 - Particular responsibilities assigned to board members
 - How 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
- Information that would inform an audit committee's or investor's consideration of the audit firm's commitment to factors that impact audit quality, including:
 - How the firm defines audit quality
 - How the firm has designed its processes and procedures to monitor and assure audit quality, including:
 - Disclosure of required and voluntary firm-wide key indicators of audit quality
 - Workload measure
 - Experience measure
 - Other measures
 - Related qualitative information⁴⁷

⁴⁷ *Id.* (with minor modifications).

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

Sincerely,

A handwritten signature in cursive script that reads "Jeff Mahoney". The signature is written in black ink and is positioned above the printed name.

Jeffrey P. Mahoney
General Counsel