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Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

Submitted via email to comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 057 — Proposed Amendments to QC 1000, *A Firm's System of Quality Control*

Dear Office of the Secretary:

Thank you for the opportunity to comment on the Board's supplemental release proposing targeted amendments to QC 1000, *A Firm's System of Quality Control*, and related amendments to PCAOB forms and the QC reporting rule (PCAOB Release No. 2026-002) ("Proposing Release"). I am a recently retired staff member at the PCAOB, with 12 years' experience in the Office of General Counsel, and I am in the process of establishing a consulting practice for small- to mid-sized registered audit firms (i.e., firms with less than 100 audit clients, including certain non-U.S. members of global networks) ("triennial firms").[1] I did not work on the substance of QC 1000 at any stage of its development while I was at the PCAOB. However, based on my extensive experience advising the Division of Registration and Inspections on issues related to firm inspections, compliance with PCAOB rules and audit standards, PCAOB and SEC independence requirements, and remediation of quality control deficiencies, as well as post-PCAOB discussions with triennial firms, I have some thoughts on how the proposed amendments to QC 1000 will impact many of these audit firms. I am submitting this letter on my own behalf, and I am not being compensated by, and do not currently have an engagement with, any client in connection with this comment letter.

For the most part, the proposed amendments should be helpful for triennial firms seeking to adapt to new quality control standards. The proposed amendments directly address areas of concern raised by triennial firms in response to QC 1000 in the form in which it was adopted,

[1] I will refer to these firms as "triennial firms," since, under the Sarbanes-Oxley Act, they are generally required to be inspected by the PCAOB on a triennial basis, as opposed to "annual firms," those with 100 or more audit clients, which are required to be inspected on an annual basis.

and the amendments should significantly reduce uncertainty and compliance costs in many respects. However, as discussed below, there are several instances in which the proposed amendments may create some new uncertainties, albeit much more limited in scope. Fortunately, these concerns can largely be met through staff guidance (particularly issuance of Spotlights[2] on early inspection observations) and/or very minor tweaks to the rule language.

Since my concerns with the proposed amendments are for the most part quite limited, and overall the proposed amendments seem constructive and clear, this letter will not try to itemize the aspects of the proposed amendments with which it agrees. Instead, this letter will focus on a few aspects of the proposed amendments that, from the perspective of triennial firms, may require further consideration or clarification by the Board. The discussion that follows is organized around certain of the specific requests for comments set out in the text of the Proposing Release.

The main points that I will expand on below are

1. As discussed in connection with Question 1 below, there seems to be a disconnect between the text of the proposed amendments and the economic analysis with regard to the rescission of the design-only requirement. This may create confusion for triennial firms as to whether the Board intends for some vestige of the "design-only" requirement to remain for firms that are not conducting PCAOB audits.
2. As discussed in connection with Question 3 below, it would be helpful if the staff issued one or more Spotlights in the early days after it has begun inspecting for compliance with QC 1000 to help firms, particularly smaller firms, understand any concerns that the Board has identified, as well as effective practices in designing, implementing and operating QC 1000 compliant systems that PCAOB inspection teams have observed.
3. As discussed in connection with Question 21 below, there is ambiguity as to how the evaluation date and the Form QC filing date set out in paragraph .77 operate together in some circumstances. It would be helpful to have additional guidance on what the Board and the staff expect in situations where a firm concludes on effectiveness as of the evaluation date, but subsequent testing prior to the filing of Form QC calls that conclusion into question. Specifically, a statement that the PCAOB will not consider it a QC deficiency for a firm to reverse its evaluation date conclusion on effectiveness based on subsequent testing results would help to avoid creating any perverse incentives for firms to avoid effective testing or to rationalize away adverse testing results.

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[2] "Spotlights" refers to staff publications about aggregated inspection observations issued under the authority of PCAOB Rule 4010. That rule provides, in pertinent part, that "the Board may, at any time, publish such summaries, compilations, or other general reports concerning the procedures, findings, and results of its various inspections as the Board deems appropriate. Such reports may include discussion of criticisms of, or potential defects in, quality control systems of any firm or firms that were the subject of a Board inspection," so long as firms as to which nonpublic quality control criticisms have been made are identified. Rule 4010 seems ideal for PCAOB dissemination of information about issues related to QC 1000 identified in staff inspections, and Spotlights, which many triennial firms look to for insights, seems like a logical means to transmit that information.

4. As discussed in connection with Questions 26 and 27 below, I support the suggestion of creating an option, at least for triennial firms, to make binary conclusions under Paragraph .77 as to the effectiveness of their QC systems. For a firm with a limited pool of PCAOB audit engagements and limited resources, it will likely be more challenging than for larger and more sophisticated firms to have to parse its monitoring and remediation activities for the nuanced distinctions made in Paragraph .77(b). Giving such a firm the option to simply choose whether its QC system is or is not effective in achieving the reasonable assurance objectives would be a much more viable approach for many such firms and may produce more useful information for the Board than asking them to navigate the subtleties of Paragraph .77(b).

This letter also notes some other areas of slight ambiguity in the proposal, all of which could be fixed with some minor technical drafting or additional guidance.

Comments on Specific Aspects of the Proposed Amendments

Question 1. Is the proposed rescission of the design-only requirement appropriate? Why or why not?

The rescission of the design-only requirement is appropriate for the reasons set out in the Proposing Release. I comment on this question only to point out what appears to be a disconnect between the language of the proposed amendment to QC 1000.06 and the economic analysis component of the Proposing Release.

While the text of .06 explicitly states that the design, implementation, and operation requirements of QC 1000 only apply at times when a firm "is required to comply with applicable professional and legal requirements with respect to any of the firm's engagements," the economic analysis begins with the premise that "QC 1000 applies to all [PCAOB-registered] firms" whether or not conducting PCAOB audit engagements, and the analysis includes data that seems to imply that there would continue to be a very substantial population of "design-only" firms. See Table 1 on p. 55 of the Proposing Release. The confusion deepens with the conflicting statement on page 61 of the economic analysis that "[t]he proposed amendments would rescind the requirement for design-only firms to design a QC system that complies with QC 1000." It is unclear how to reconcile these statements in the economic analysis with each other, or the Table on page 55 with the text of the proposed amendment to QC 1000.06.

Most likely this is simply a vestige mistakenly carried forward from the economic analysis of the prior version of QC 1000. However, if the Board or the staff has a view that under the amended QC 1000 there will continue to be some PCAOB-registered firms that will in some way be subject to a design requirement even if they do not conduct engagements under PCAOB standards, that view needs to be explained and reconciled with the plain text of the proposed amended Paragraph .06. If, as is likely, this is simply a mistake in the economic analysis, it would be helpful to correct this aspect of the economic analysis to avoid confusion.

Question 3. Are there activities that should trigger a QC-system design requirement before a firm becomes subject to applicable professional and legal requirements in connection with an engagement? If so, what are they, and why should they trigger a design requirement?

Retaining some form of design requirement for firms not conducting an audit engagement under PCAOB standards is inadvisable for the reasons set out in the Proposing Release. In addition to those reasons, another consideration is that there is likely to be significant variance between firms as to what design of a QC system entails. This variance makes a one-size-fits-all requirement impractical. However, while it may not be appropriate as a regulatory requirement, it certainly could be a good practice for firms to begin developing QC 1000-compliant systems when they anticipate becoming subject to the QC 1000 requirements. As the Board notes on page 14 of the Proposing Release,

> "such firms could still choose to design (and for that matter, implement and operate) a QC system that complies with QC 1000… if, for example, they are planning to bid for a PCAOB engagement, are taking on work on other firms' engagements that could potentially constitute a substantial role, or otherwise wanted to put themselves in a position to implement and operate a QC 1000-compliant system on short notice."

Encouraging, but not requiring, triennial firms to "jumpstart" design of a QC 1000-compliant system when they anticipate that they will become subject to QC 1000 in the near future seems like the right policy approach. To that end, it might be helpful if, with the benefit of early experience inspecting firms for compliance with QC 1000, the PCAOB made it a priority to issue a Spotlight on the experience of triennial firms that opted to begin designing, implementing or operating a QC 1000-compliant QC system in advance of accepting a PCAOB engagement or a substantial role in such an engagement, including effective practices that the inspection staff has observed. Even if not required, information about the experiences of firms in such situations could be beneficial to the compliance efforts of other triennial firms. In particular, a firm that is not subject to either ISQM-1 or SQMS-1 might find it very helpful to have insight into effective steps that similarly-situated firms have undertaken to prepare themselves for compliance with QC 1000.

Question 7. Should the proposed amendments to paragraphs .12 and .15-.17 be available only on a scaled basis (e.g., only to firms that issued audit reports for fewer than 100 issuers in the prior calendar year)? If so, why, and what should the relevant thresholds be?

The proposed amendments to these paragraphs should be especially helpful to triennial firms. The flexibility afforded seems appropriate regardless of firm size, although simply because of their size and increased resources larger firms are better positioned to cope with a more restrictive and specialized set of rules.

Question 13. Are the proposed amendments to paragraph .53e sufficiently clear and appropriate? If not, why not?

The proposed amendments to this paragraph are generally clear and seem appropriate. I have one very minor suggestion – the word "metric" is not defined or explained in the rule text.

The text of the Proposing Release helpfully clarifies that "metric" means a calculated measure, rather than underlying data. As a drafting point, it might be useful if the rule text captured that point. A smaller, less sophisticated firm might not know to consult the discussion in the Proposing Release for clarification of terms in the rule that are not entirely clear on their face.

Question 18. Are the proposed amendments to the definition of QC deficiency to take into account other quality responses (e.g., compensating responses) appropriate and clear? Why or why not?

The proposed amendments to this definition are also generally clear and appropriate. One minor suggestion is that the rule text might clarify that multiple other quality responses are not necessarily required. For example, the note to A.8(1) could add the words "one or more" before "other quality responses." It seems highly likely that, in situations where there is just one quality response, the Board did not mean to exclude taking that response into account, but neither the rule text nor the accompanying discussion in the Proposing Release make that entirely clear.

Question 21. Is the proposed evaluation framework for concluding on the effectiveness of a firm's QC system, including the three proposed conclusions in paragraph .77, sufficiently clear and appropriate? Why or why not?

The proposed evaluation framework in paragraphs .77 and .78 is generally clear and appropriate, with two exceptions. The first and more significant concern is that there is some ambiguity as to how the evaluation date and the Form QC filing date set out in paragraph .77 operate together in some circumstances. Paragraph .77 expressly provides that a firm must conclude on effectiveness by the evaluation date. However, it goes on to qualify this, noting that while "implementation must be completed as of the evaluation date[,]…testing and the determination of effectiveness must be completed no later than the date Form QC is due."[3]

It seems clear enough that the "[a]ssessment of whether actions are operating effectively may be supported by evidence obtained from testing after the evaluation date but before the Form QC filing date." Proposing Release at 36. It makes good sense to give firms right up until they file their Form QC to fully and properly test remedial action. The concern is simply how this latitude to test until the filing of Form QC sits with the language in Paragraph .77 that a firm "*must evaluate* the effectiveness of its QC system, based on the results of its monitoring and remediation activities, *and conclude, as of the evaluation date*" on its effectiveness (emphasis added).

What would this mean, for example, if a firm introduced, prior to the evaluation date, new software to address an identified QC deficiency, and concluded as of the evaluation date, that the software was operating effectively to remediate the deficiency, only to find, on the verge

[3] Paragraph .78 further explains that in reaching this conclusion on evaluation date the firm should take into account the severity and pervasiveness of all unremediated QC deficiencies. Paragraph .78 then lists the factors that the firm should consider in evaluating severity and pervasiveness. These factors include "[t]he effects of any remedial actions that have been implemented, tested, and found to be effective." Paragraph .78(h).

of its Form QC filing, that further testing had revealed shortcomings in the software's operation? Presumably the Board would **not** want the firm to stand by its effective date conclusion in its Form QC filing. However, the Proposing Release is silent as to the latitude of firms to change their conclusions from the effective date to the date that Form QC is filed. Might it constitute a new quality control deficiency if a firm has to reverse its evaluation date conclusion about effectiveness due to weaknesses that surface in subsequent testing? If so, might that create a troubling incentive for a firm to not test its remedial actions as vigorously as it should, or an incentive to explain away poor test results so that it does not have to reverse its effective date conclusion? Rather than inadvertently incentivizing firms to avoid vigorous testing and unflinching consideration of adverse testing results, it would be helpful to clarify that nothing in paragraphs .77 or .78 is intended to discourage a firm from changing its evaluation date conclusions in its Form QC filing in light of subsequent test results. This could simply be done by staff guidance that such a reversal of an evaluation date conclusion would not in itself give rise to a need for a firm to treat the reversal as a QC deficiency, and assurance that it would not give rise to a potential QC deficiency finding in Part II of a PCAOB inspection report.

A less significant point is that the word "component" as used in paragraph .78 is not defined or explained in the rule text. Page 39 of the accompanying discussion in the Proposing Release indicates that it means a component of a firm's quality control system. That presumably harkens back to QC 1000.03, which lays out "eight integrated components of a firm's QC system."[4] It is very likely that the term "component" in paragraph .78 means the integrated components set out in paragraph .03, but the connection between the two could be stronger with a cross-citation, or by using the term "integrated components" in both places.

Question 26. Would the alternative evaluation framework with a binary conclusion (i.e., that the QC system is either effective or not effective in achieving the reasonable assurance objective) be more appropriate for evaluating the effectiveness of the QC system? Why or why not?

Question 27. Under the alternative evaluation framework with a binary conclusion, would it be appropriate to retain the factors in paragraph .78 as adopted? Why or why not? Are there other factors that would be helpful in determining the evaluation conclusion? If so, what are they, and how would they be helpful?

Responding briefly to questions 26 and 27 together, the option of a binary conclusion would be appropriate for many triennial firms. For a firm with a limited pool of PCAOB audit engagements and limited resources, it will likely be more challenging than for larger and more

[4] These are: a. the firm's risk assessment process; b. governance and leadership; c. ethics and independence; d. acceptance and continuance of engagements; e. engagement performance; f. resources; g. information and communication; and h. the monitoring and remediation process. QC 1000.03

sophisticated firms to have to parse its QC system for the nuanced distinctions made in Paragraph .77(b) of systems that are

- effective, except for unremediated QC deficiencies that
    - have a "severe" effect on the operation of its QC system,
    - but that effect
        - is not "pervasive," and
        - does not "render the QC system not effective."

Candidly, it seems likely that smaller firms with limited resources will find interpreting and applying these variables a challenge, and they may as a consequence report results that are very inconsistent, either between firms, or year-by-year for each firm. Giving a triennial firm, or at least a firm on the smaller end of the spectrum, the option to simply choose whether to designate its QC system as effective or not effective in achieving the reasonable assurance objectives would be a much more viable approach for many such firms and may ultimately give the Board more useful information on Form QC. Of course, if a triennial firm prefers to forego a binary approach and remain subject to all three branches of Paragraph .77, it should also have that option.

The factors set out in Paragraph .78 seem just as appropriate for a binary as for a ternary approach, so it probably would not be necessary to change those factors to accommodate a binary approach.

Conclusion

It is commendable that the Board has engaged thoughtfully with the practical implementation concerns smaller firms have raised since QC 1000's adoption. The proposed amendments should advance the important goal of continual improvement in firms' quality control systems. While I urge the Board to address the limited concerns raised above, overall the proposed amendments should be very helpful, and I hope that the Board will adopt the amendments and that the SEC will approve them in short order.

I appreciate the opportunity to comment and would welcome the opportunity to discuss further any of the points above.

Respectfully submitted,

George R. Kramer