



## **RELEASE**

### **Introduction**

The quality of a firm's audit practice is directly affected by the quality of supervision within the firm. Supervision responsibilities are imposed by and rooted in the Board's auditing standards and quality control standards and are carried out by individuals at all levels within a firm. Through its inspections and investigations, the Board has observed that, to some extent, the execution of those supervisory processes sometimes suffers from a lack of diligence. The Board has also at times observed that the quality of supervision within a firm has been affected by a lack of clarity regarding the allocation of various supervisory responsibilities at different levels.

The Board is issuing this Release for two reasons. First, the Board sees value in generally reminding registered firms and associated persons of the authority provided to the Board in section 105(c)(6) of the Act, captioned "Failure to Supervise." That section authorizes the Board to impose sanctions on a registered public accounting firm or its supervisory persons for a failure to reasonably supervise, with a view to preventing certain violations, an associated person who commits such a violation. Part I of this release is intended to highlight the scope of section 105(c)(6)'s application. Part I should not be understood as a proposal, and the Board is not seeking comment on Part I.<sup>1/</sup>

Second, the Board is considering proposing rules that, without imposing any new supervision responsibilities in the Board's auditing standards and quality control standards, would require firms to make and document clear assignments of the supervision responsibilities that are already required to be part of any audit practice. The Board is considering whether such rules would serve to further the public interest and protect investors by increasing clarity about who within the firm is accountable for various responsibilities that bear on the quality of the firm's audits. Part II of the Release solicits comment on specific rulemaking concepts. The Board will take all comments on Part II into account in considering whether to propose such rules.

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<sup>1/</sup> Part I does not modify existing legal requirements, create new legal requirements, or constitute a rule of the Board (as defined in section 2(a)(13) of the Act), nor is it published as bearing the Securities and Exchange Commission's official approval. Any specific application of section 105(c)(6) could, of course, be contested by a respondent in a disciplinary proceeding, who could present arguments to the Board and also obtain review of Board findings and sanctions by the Commission and the federal court of appeals.

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### I. Section 105(c)(6)

Under section 105(c)(6) of the Act, if an associated person of a registered public accounting firm violates any provision of law, rules, or standards referenced there, the Board may – in addition to imposing sanctions on that person – impose sanctions on other individuals or the firm if the Board finds that there was a failure reasonably to supervise that associated person.<sup>2/</sup> This part of the Release describes the Board's approach to the application of section 105(c)(6).

Part I.A. discusses section 105(c)(6)(A), which provides the authority to impose sanctions for failure to supervise. Part I.B. discusses the supervision-related obligations inherent in the Board's existing standards, particularly the quality control standards, and the connection between those obligations and the Board's application of section 105(c)(6). Part I.C. discusses section 105(c)(6)(B)'s "rule of construction," which describes the elements of an affirmative defense to the imposition of sanctions for failure to supervise.<sup>3/</sup>

#### A. Section 105(c)(6)(A)

Section 105(c)(6)(A) provides that the Board may impose sanctions on a registered firm or a "supervisory person of such firm"<sup>4/</sup> if an associated person of the

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<sup>2/</sup> Legislative history indicates that section 105(c)(6) was intended to provide "terms for liability for failure to supervise [that] are similar to those that apply to broker-dealers under section 15(b)(4) of the Securities Exchange Act of 1934." S. Rep. No. 205, 107<sup>th</sup> Cong., 2d Sess. (June 26, 2002) ("Senate Report") at 11, 49.

<sup>3/</sup> Section 105(c)(6) was also the topic of a panel discussion at a public meeting of the Board's Standing Advisory Group on February 27, 2008. A staff briefing paper prepared for that discussion and an archived webcast of the discussion can be accessed through links at [www.pcaobus.org/News/Events/Pages/02272008\\_SAGMeeting.aspx](http://www.pcaobus.org/News/Events/Pages/02272008_SAGMeeting.aspx).

<sup>4/</sup> As originally enacted, Section 105(c)(6)(A) referred to "the supervisory personnel of such firm." To clarify that the Board's sanctioning authority is not limited to persons who are supervisory personnel at the time the sanction is imposed, the Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 105(c)(6)(A) by changing "the supervisory personnel of such firm" to "any person who is, or at the time of the alleged failure reasonably to supervise was, a supervisory person of such firm." The "supervisory person" and "supervisory personnel" terminology are used interchangeably in this Release.

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firm commits certain violations (hereafter, "predicate violations") and "the firm has failed reasonably to supervise [that person] either as required by the rules of the Board relating to auditing or quality control standards, or otherwise, with a view to preventing" such violations (emphasis added).<sup>5/</sup> In the discussion that follows, the two components of the underlined language are referred to as the "rules clause" and the "or otherwise" clause.

In isolation, the rules clause of section 105(c)(6) would be essentially redundant of authority provided to the Board elsewhere in the Act. That is, to the extent the Board adopts rules or standards related to supervision, the sanctioning authority provided through the rules clause of section 105(c)(6)(A) overlaps significantly with the broad authority to impose sanctions for all violations of rules or standards provided in section 105(c)(4). In fact, without invoking section 105(c)(6), the Board has previously exercised its section 105(c)(4) authority to impose sanctions against a firm for a violation of a standard related to supervision.<sup>6/</sup>

On the other hand, the range of conduct that the Board might address through the "or otherwise" clause encompasses conduct not covered by any supervision rules or standards. For conduct in this category, the Board's authority to impose sanctions is found only in section 105(c)(6) and involves case-by-case determinations concerning the reasonableness of supervision in particular circumstances, without regard to whether any specific supervision rules or standards are implicated.<sup>7/</sup>

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<sup>5/</sup> Predicate violations include violations of the Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission under the Act, or professional standards.

<sup>6/</sup> See In the Matter of Deloitte & Touche LLP, PCAOB Release No. 105-2007-005 (December 10, 2007) at 5 & n.4 (censuring firm and imposing a civil money penalty because, among other things, firm failed to staff an audit engagement in accordance with AU § 230.06).

<sup>7/</sup> The Senate Report supports this reading. It describes section 105(c)(6) as permitting the Board "to impose sanctions upon a registered accounting firm for failure reasonably to supervise a partner or employee who is found to have violated applicable rules," and does not suggest that the sanctioning authority is limited to circumstances involving a firm's or supervisor's violation of supervision rules. Senate Report at 11. This reading is further supported by the Senate Report's description of the terms for Section 105(c)(6) liability as being "similar to those that apply to broker-dealers under section 15(b)(4) of the Securities Exchange Act," Senate Report at 11,

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This understanding – that section 105(c)(6) could be applied even in the absence of specific supervision rules – informed a view that the Board expressed in adopting its enforcement rules in 2003. The Board's proposed rules had included what is now Rule 5200(a)(2), a procedural rule relating to the commencement of disciplinary proceedings for failure to supervise. Some commenters urged that the Board should spell out what it means to fail reasonably to supervise and also asserted that differences between accounting firm structures and broker-dealer structures precluded accounting firms from gleaned any guidance from section 15(b)(4) precedent. In addressing those comments, the Board stated:

At this time, we are not providing specific guidance on the scope of supervisory liability under the Act. We will continue to consider whether additional guidance or rulemaking on this point would be appropriate. . . . [However,] even in the absence of additional, specific guidance, investigations may uncover circumstances in which it would be appropriate, under any reasonable reading of the Act, to commence disciplinary proceedings for failure to supervise.<sup>8/</sup>

The Board continues to view section 105(c)(6) as a provision that would be available for the Board to apply in an appropriate case, including through the "or otherwise" clause, without the need to adopt any implementing rules or to provide guidance.

### B. The Scope of Section 105(c)(6)(A)

This section discusses two aspects of the scope of section 105(c)(6)(A). First, in providing that the Board may impose sanctions on a firm or upon a "supervisory person" of a firm, how, if at all, does section 105(c)(6)(A) limit the universe of associated persons whom the Board may sanction for failure to supervise? Second, what areas of responsibility could be understood as involving responsibility to "supervise" in the sense that makes the conduct reachable through section 105(c)(6)(A)?

#### 1. Individuals Who May Be Sanctioned Under Section 105(c)(6)(A)

To the extent that Board auditing standards prescribe supervision obligations for any specified category of individuals, they are essentially limited to obligations imposed

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49, since the imposition of sanctions for failure to supervise under section 15(b)(4) does not depend upon the Commission finding a violation of supervision rules.

<sup>8/</sup> Rules on Investigations and Adjudications, PCAOB Release No. 2003-015 (September 29, 2003) at A2-59.

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on members of the audit engagement team.<sup>9/</sup> Before the Board adopted Rule 5200(a)(2) in 2003,<sup>10/</sup> some commenters on the proposed rule encouraged the Board to limit the scope of section 105(c)(6) supervisory personnel to the engagement partner and the audit manager.

As the Board stated in response to those comments, however, the Board sees "no reason . . . to limit the persons who may have supervisory liability to those occupying certain positions."<sup>11/</sup> The reach of section 105(c)(6) is not limited in that way. Nor does anything in section 105(c)(6) indicate that the term "supervisory person" limits that section's reach to those with direct and immediate supervisory responsibility for the associated person who commits the violation. Any associated person in the firm, including even the most senior personnel of very large firms, could be a "supervisory person" for section 105(c)(6) purposes depending upon the nature of their responsibility, ability, or authority in relation to the conduct of the associated person who commits a predicate violation.

It does not follow, though, that each person with such responsibility, ability, or authority in relation to a particular predicate violation could be sanctioned merely because the predicate violation occurred, absent a finding that the individual failed to reasonably supervise the associated person. In the Board's view, section 105(c)(6) sanctions would be appropriate only where, in relation to the predicate violation, there has been a failure to exercise such responsibility, ability, or authority reasonably with respect to an associated person.

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<sup>9/</sup> See AU § 311, *Planning and Supervision*. On August 5, 2010, the Board adopted standards that, if approved by the Commission, will replace AU § 311, including Auditing Standard No. 10, *Supervision of the Audit Engagement* ("AS No. 10"). As with AU § 311, the supervision obligations described in AS No. 10 are essentially limited to obligations imposed on members of the audit engagement team.

<sup>10/</sup> Rule 5200(a)(2) is a procedural rule providing that the Board may commence a disciplinary proceeding when it appears to the Board that a hearing is warranted to determine whether a registered firm or its supervisory personnel have failed reasonably to supervise an associated person with a view to preventing the predicate violations.

<sup>11/</sup> Rules on Investigations and Adjudications, PCAOB Release No. 2003-015 (September 29, 2003) at A2-59.

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### 2. Relevant Supervision Responsibilities

Some supervision responsibilities are rooted in certain Board auditing standards. For example, AU § 311 and its Board-adopted successor concerning supervision, AS No. 10, discussed above, impose certain obligations on the engagement partner to supervise the work performed on a particular audit. AU § 230.06 imposes a particular supervision obligation on a firm, in connection with work on a particular audit, by requiring that the firm assign to the audit an engagement partner with sufficient knowledge of the relevant professional standards and of the client.

Additional supervision responsibilities are rooted in the Board's quality control ("QC") standards.<sup>12/</sup> The introduction to the QC standards notes that they relate to "quality control procedures to ensure that services are competently delivered and adequately supervised."<sup>13/</sup> The QC standards broadly define a system of quality control as "a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality."<sup>14/</sup> The QC standards include a section on monitoring a firm's audit practice,<sup>15/</sup> and include a section on a firm's responsibilities related to staffing audits, particularly the firm's responsibilities concerning the competencies of the "practitioner-in-charge" of an audit.<sup>16/</sup> Associated persons who have responsibility related to implementation of

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<sup>12/</sup> By "quality control standards," this Release is referring to requirements adopted by the Board in PCAOB Rule 3400T as interim quality control standards (available at [www.pcaobus.org/Standards/QC/Pages/default.aspx](http://www.pcaobus.org/Standards/QC/Pages/default.aspx)).

<sup>13/</sup> QC § 20.02.

<sup>14/</sup> QC § 20.03.

<sup>15/</sup> QC § 30, "Monitoring a CPA Firm's Accounting and Auditing Practice," includes detail on how a firm should implement the monitoring element of its quality control system through internal inspection and related steps.

<sup>16/</sup> QC § 40, "The Personnel Management Element of a Firm's System of Quality Control – Competencies Required by a Practitioner-in-Charge of an Attest Engagement," includes detail concerning the need for a firm's quality control system to provide reasonable assurance that "[w]ork is assigned to personnel having the degree of technical training and proficiency required in the circumstances," QC § 40.02, to provide reasonable assurance that the practitioner-in-charge "possess[es] the kinds of competencies that are appropriate given the circumstances of individual client engagements," QC § 40.03, and to address the ways in which the practitioner-in-charge gains and maintains those competencies, QC § 40.04-08.

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components of those categories – whether broadly or with respect to only a portion of the firm's audit practice – have responsibilities that, depending on the facts and circumstances, could be understood as supervision responsibilities in relation to an individual associated person.<sup>17/</sup>

For example, QC § 20.13 and, in more detail, QC § 40, address the need for a firm to have policies and procedures to provide reasonable assurance that the firm will staff audits with personnel, including engagement partners, who have the technical proficiency and competencies necessary for the particular audit. While the obligation to have in place an adequate system for that purpose is an obligation of the firm, staffing decisions made pursuant to the firm's system are made by individuals (or groups of individuals). If a predicate violation occurs in a particular audit because the engagement partner lacked the necessary proficiency and competencies, any associated person of the firm who unreasonably carried out responsibility in relation to assigning that partner to the audit, or who, having authority for that staffing, unreasonably carried out responsibility for monitoring whether that staffing remained appropriate, could, depending upon the facts and circumstances, be sanctioned under section 105(c)(6) for failure reasonably to supervise the associated person who committed the predicate violation. That is not to say that the conduct of any such persons would be viewed as necessarily unreasonable just because of the engagement partner's predicate violation; it is merely to say that such conduct could be understood under the facts and circumstances as involving supervision of the associated person, and unreasonable conduct in that context could therefore lead to sanctions under section 105(c)(6).<sup>18/</sup>

To take another example, QC § 20.20, and, in more detail, QC § 30, require firms to have policies and procedures to monitor, such as through internal inspections, compliance with the firm's policies and procedures in connection with audits. Under a

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<sup>17/</sup> Of course, the Board can and does enforce firms' compliance with quality control standards even apart from whether section 105(c)(6) applies. The Board not only enforces compliance with those standards by firms, but also, under PCAOB Rule 3502, may impose disciplinary sanctions against an individual whose failure reasonably to carry out QC responsibilities contributes to a firm's violation of QC standards.

<sup>18/</sup> Section 105(c)(6) does not require a scienter finding as a condition to the imposition of sanctions for failure reasonably to supervise. Cf. In the Matter of Clarence Z. Wurts, SEC Release No. 34-43842 (January 16, 2001) (scienter "is not an element of a failure-to-supervise charge" under the Exchange Act). The Board's authority to impose certain more severe sanctions, however, is limited by section 105(c)(5) to circumstances involving intentional or knowing conduct, including reckless conduct, or repeated instances of negligent conduct.

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firm's system, though, there will be individuals who have responsibility, ability, or authority to consider internal monitoring findings about deficiencies in an associated person's conduct and to take steps to decrease the likelihood of such deficiencies being repeated. If an individual with that responsibility, ability, or authority fails to take reasonable steps to address competency or conduct issues relating to that associated person, then, depending on all of the facts and circumstances, the connection between that failure and subsequent predicate violations by that associated person could suffice to justify the imposition of sanctions under section 105(c)(6).

Similar examples could be drawn from various other provisions of the QC standards. In general, whether a sufficient connection exists between unreasonable supervisory conduct and a particular predicate violation to warrant the imposition of sanctions pursuant to section 105(c)(6), or whether sanctions would be appropriate on some other basis, will depend on the specific facts and circumstances. The overarching point is that individuals' responsibilities for implementing a firm's QC policies and procedures are responsibilities that relate to supervision and, given a sufficient connection to a predicate violation, could, if unreasonably carried out, result in sanctions under section 105(c)(6).

### C. Section 105(c)(6)(B)'s "Rule of Construction"

Section 105(c)(6) does not create a form of strict "failure to supervise" liability for the firm or supervisory personnel just because an associated person has committed a violation. Section 105(c)(6)(B) provides the possibility of an affirmative defense that could preclude the Board from imposing sanctions against a supervisory person for failure to supervise. Section 105(c)(6)(B) provides that no supervisory person can be found to have failed reasonably to supervise under section 105(c)(6)(A) if all of the following conditions are satisfied: (1) the individual reasonably discharged the supervisory duties placed on him or her by the firm's procedures, (2) the individual had no reasonable cause to believe the firm's procedures were not being complied with, and (3) the firm's procedures comply with applicable Board rules and would reasonably be expected to prevent and detect the violation.

Section 105(c)(6)(B) would not play a role in a disciplinary proceeding unless the respondent introduced it as an affirmative defense. That is, it is not necessary for the Board affirmatively to find, as an element supporting the imposition of sanctions, that one or more of the three elements described above was not satisfied. Rather, a respondent who seeks to rely on section 105(c)(6)(B) would bear the burden of raising it and establishing that all three elements are satisfied. The Senate Report supports this view, stating that the provisions of section 105(c)(6) "permit an accounting firm to

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defend itself from supervisory liability by showing that its internal control procedures were reasonable and were operating fully in the situation at issue."<sup>19/</sup>

### II. Possible Rulemaking Approaches, Including Standard-setting, to Complement Application of Section 105(c)(6)

As mentioned above, the Board has, through inspections and investigations, at times observed that the quality of supervision within a firm was affected by a lack of clarity regarding the allocation of various supervisory responsibilities at different levels within the firm's practice. The Board is therefore considering proposing rules requiring firms to make and document clear assignments of relevant supervision responsibilities throughout the firm. The Board is considering whether such rules would serve to further the public interest and protect investors by increasing clarity about who within the firm is accountable for various supervisory responsibilities that bear on the quality of the firm's audits.

The types of rules the Board is considering would not create new supervision responsibilities but would only address how clearly firms assign responsibilities that are already required to be part of any audit practice.<sup>20/</sup> Rules requiring firms to make and document clear assignments of responsibility for implementing necessary QC policies and procedures would help avoid potential confusion within a firm about where significant responsibility rests – confusion that can lead to gaps in supervision with consequent violations of professional standards. In addition, such rules would facilitate the Board's assessment, through the inspection process, of a firm's supervisory

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<sup>19/</sup> Senate Report at 11 (emphasis added). By its terms, section 105(c)(6)(B) addresses only the possibility of precluding section 105(c)(6)(A) sanctions against a supervisory person, and it does not address the possibility of precluding such sanctions against a firm. As a practical matter, however, the Board would not expect to impose section 105(c)(6)(A) sanctions against a firm if the Board were persuaded that the section 105(c)(6)(B) conditions were satisfied.

<sup>20/</sup> The suggested rules would be in addition to QC § 20.22, which provides in part, "Responsibility for the design and maintenance of the various quality control policies and procedures should be assigned to an appropriate individual or individuals in the firm. In making that assignment, consideration should be given to the proficiency of the individuals, the authority to be delegated to them, and the extent of supervision to be provided" (emphasis in original).

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practices. The rules would also facilitate identifying, after a predicate violation has occurred, the persons with relevant supervision responsibilities.<sup>21/</sup>

The Board solicits comment on the concept of requiring registered firms to make and document clear assignments of responsibility for implementation of QC functions.

### Questions –

1. The principal objectives of the type of rulemaking described above would be clarity within firms about accountability for supervisory responsibilities and the creation of documentation identifying lines of accountability.
  - a. Is it appropriate to pursue the objectives through rulemaking, or are there reasons to pursue those objectives through other means?
  - b. How are those objectives typically already being met within firms? On this point, the Board is particularly interested to hear from firms, of varying sizes, their views about how their structures and their existing quality control practices achieve these objectives.
  - c. The Board is also particularly interested in hearing how investors, audit committees, and others who rely upon audited financial statements view the importance of these objectives.
2. To the extent these objectives are pursued through Board rulemaking, are there potential unintended consequences to take care to avoid, i.e., ways in which pursuing the objectives might inadvertently diminish accountability or audit quality?
3. Are there related or different rulemaking objectives that would complement application of section 105(c)(6) that should be pursued instead of, or in addition to, the objectives described here?

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<sup>21/</sup> Cf. NASD Rule 3010(b) (requiring brokers and dealers that are member firms to have written supervisory procedures and keep a record of persons designated as supervisory personnel) and NASD Notice to Members 99-45 (June 1999) at 294-295 (noting that the purpose of Rule 3010(b) is "to allow for personnel at the firm, as well as regulators, to easily determine who is responsible for supervising a particular area and the time period for which the person was assigned the supervisory responsibility").

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- a. In particular, are there ways in which the Board's quality control standards should be revised that would complement or facilitate the application of section 105(c)(6) or otherwise require firms to give increased emphasis to the role of supervision throughout their audit practice?

The Board has also preliminarily considered how such a rule might be crafted. One possibility is to formulate a rule that only in general terms requires assignment of responsibility and documentation of that assignment. Under this approach, a rule would build on the existing requirement that responsibility for the design and maintenance of QC policies and procedures be assigned to appropriate individuals<sup>22/</sup> and would require firms to document all such specific assignments, sufficient to cover the full range of the firm's obligations under the Board's QC standards, and to assign, to other associated persons, any appropriate higher-level supervisory responsibility over those persons. In other words, if a firm complied with the rule, it would be possible to identify, with respect to a particular violation in an audit, any individuals who had responsibility for any aspects of the QC system that failed, and to identify other individuals with supervisory responsibility for those individuals' performance relating to the QC system.

Another approach would involve a more detailed formulation. Under this approach, a rule would identify and define various specific areas of supervisory responsibility and would require a firm to assign responsibility in each area to specifically identified individuals. The areas of supervisory responsibility identified in a more detailed approach would be derived from the QC standards. The potential benefit of a more detailed approach would not be to encompass more or different areas of supervisory responsibility than the general approach, but would just be to make more concrete the scope of the rule's requirement and so reduce a risk posed by the general approach – that a firm might think that it has covered the relevant range of responsibilities only to have the Board identify a gap in the firm's assignments.<sup>23/</sup>

Under either the general approach or the detailed approach, a firm would have some flexibility in aspects of how it approaches compliance with the rule. For example, depending upon the size and nature of the portion of the firm's practice subject to

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<sup>22/</sup> See QC § 20.22 (quoted in note 20 above).

<sup>23/</sup> Under either approach, the Board could impose sanctions for noncompliance with such a rule even in the absence of any other violations. That is, unlike sanctions for a failure reasonably to supervise under section 105(c)(6), the firm's failure to comply with the assignment and documentation rule would be an independent basis, under section 105(c)(4) of the Act, for sanctions against the firm or associated persons who contribute to the firm's violation of the rule.

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PCAOB standards, one firm might choose to satisfy the rule by resting with a single person all responsibility for all areas, while another firm might divide each single area of responsibility among several people.

The Board solicits comments on the possible approaches to such an assignment rule.

### **Questions –**

4. What are the relative advantages and disadvantages of the two approaches described?
5. Are there significantly different approaches that might effectively accomplish the relevant objectives?
6. If the Board were to pursue the more detailed approach described above, how should the Board approach identifying the appropriate degree of detail?
7. Are there identifiable areas of responsibility that should be included in any such detailed approach even though they do not necessarily correspond to aspects of the QC standards?

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Interested persons are encouraged to submit to the Board their views on the issues discussed in Part II of this Release. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's Web site at [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to PCAOB Rulemaking Docket Matter No. 31 in the subject or reference line and should be received by the Board no later than November 3, 2010. The Board will consider all timely comments received on Part II.

On the 5th day of August, in the year 2010, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour  
Secretary

August 5, 2010