



# AFL-CIO

AMERICA'S UNIONS

**American Federation  
of Labor and  
Congress of Industrial  
Organizations**

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February 1, 2023

By email to [comments@pcaobus.org](mailto:comments@pcaobus.org)

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, DC 20006

Re: PCAOB Release No. 2022-006, A Firm's System of Quality Control and  
Other Proposed Amendments to PCAOB Standards, Rules, and Forms

Dear Board Members:

On behalf of the American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO"), I am writing to provide comments on the Public Company Accounting Oversight Board (the "PCAOB") proposed quality control standard for public accounting firms (PCAOB Release No. 2022-006). The AFL-CIO is a voluntary federation of 58 national and international labor unions that represent 12.5 million working people. Union members participate in the capital markets as individual investors and as participants in pension and employee benefit plans. As demonstrated by the corporate scandals of the Enron era when working people saw their retirement savings evaporate due to accounting fraud, retirement security depends in significant part on auditors performing high quality audits. As noted by the release, requiring effective quality control systems will help ensure high quality audits.

## I. Reliance on International Standards

In our March 16, 2020 comment letter on PCAOB Release No. 2019-003, Potential Approach to Revisions to PCAOB Quality Control Standards, we expressed concern regarding the PCAOB's excessive reliance on the International Standard on Quality Management 1 ("ISQM 1"), the quality control standard adopted by the International Auditing and Assurance Standards Board ("IAASB"). We were concerned that in doing so, the PCAOB would effectively "sacrifice U.S. quality control standards on the altar of international convergence." We favored a more independent oversight mechanism for the system of quality control, including reliance on independent directors, and called for increased public disclosure, including audit quality indicators, in order to facilitate public accountability with respect to quality control.

While the PCAOB's current proposal takes some steps in addressing the concerns that we highlighted in 2020, these concerns have not been adequately resolved. Notably, we were concerned that the IAASB's principles-based approach in ISQM 1 does not always reflect the best interests of investors.

When the PCAOB issued its quality control standards concept release, the IAASB had not yet finalized ISQM 1. Now that the IAASB has done so, the PCAOB is in the regrettable position of having to follow rather than lead the standard setting process. Perhaps as a result, the PCAOB has chosen to rely on ISQM 1 as its proposed quality control framework, referencing this international standard more than 100 times in the current proposed release. With the PCAOB's more active standard setting agenda now in place, we are confident that the PCAOB will again be leading global standard setting efforts in the future.

In relying on ISQM 1, the current proposal does not sufficiently reflect the unique considerations of U.S. markets and investors. One example is the proposed standard's reasonable assurance objective for an effective quality control system. Consistent with ISQM 1, the proposal defines the objective of a system of quality control as meeting existing auditing standards and other regulatory requirements, a low bar. In justifying this approach, the PCAOB declined to require a broader objective, suggesting a lack of agreement on the definition of audit quality:

[T]here is no universal definition of what "audit quality" means beyond compliance with applicable requirements. For example, audit quality cannot simply be inferred from financial reporting quality; an audit can be deficient even though the financial statements are not, and vice versa. As a consequence, we believe making "quality" the objective would not provide sufficient notice of the applicable requirements, creating significant uncertainty for firms attempting to apply and comply with the standard.

The explanation reflects a fundamental misunderstanding about what investors expect from audits and the PCAOB's proposed system of quality control. This objective does not adequately take into account the relationship between the audit and the quality of financial disclosure.

Improving financial disclosure is the goal of audits, not mere conformity with existing standards. While conforming with existing standards can contribute to that goal, as the proposal notes, this is not enough. The PCAOB's quality control standard should set as an objective not only the meeting of standards, but also the improvement in the quality of financial disclosure. Requiring a broader audit quality objective will provide firms with incentives to select procedures that do not just minimally meet standards, but will also promote audit quality by seeking to improve financial reporting.

The need for a broader objective is apparent from problems currently arising with respect to financial disclosure and audits. Research suggests that audits fail to uncover GAAP violations

with uncomfortable frequency.<sup>1</sup> A broader objective would presumably encourage firms to adopt procedures designed to uncover more of these violations.

The proposal also relies excessively on a principles-based approach with respect to a firm's system of internal monitoring. The proposal contemplates that engagement partners will be inspected internally at least every three years, a predictable cycle. As a result, engagement partners may be aware of when they will be inspected and in a position to "manage" the results, potentially generating outcomes that do not reflect the true quality of their auditing skills.

This is not a hypothetical concern. Academics have noted that partners can often predict when they will be inspected by their firm.<sup>2</sup> Perhaps this explains some of the inadequacies in the internal inspection process identified by the PCAOB.<sup>3</sup> These concerns suggest the need for a mandatory requirement of unpredictability in the selection of internal audits for inspection.

The proposal, however, only requires that larger firms with more than 100 issuer clients "consider" whether to include some degree of unpredictability in the internal inspection process. Nor does the proposal even require consideration of unpredictability with respect to the areas of the audit engagement subject to internal inspection. This can be contrasted with the PCAOB's own practice in selecting audits for inspection<sup>4</sup> and with respect to fraud procedures.<sup>5</sup>

Unpredictability in the timing of, and the focus areas designated for, internal inspection should be a requirement rather than a principles-based consideration.

## **II. Disclosure and Accountability**

We are also concerned with the failure to provide for disclosure to investors and the public.

The proposal would require that firms establish quality objectives for communications with "external parties." The proposal lists as examples of external parties "company management, audit committees, and boards of directors; the SEC; the PCAOB; and other regulators." Investors and the public are conspicuously absent. The proposal makes no mention of the role of quality control with respect to critical audit matters ("CAMs"), an area of particular interest to investors,

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<sup>1</sup> J. Alexander Dyck, Adair Morse, & Luigi Zingales, "How Pervasive is Corporate Fraud?," *Review of Accounting Studies* (2023) ("Accounting violations, less severe than alleged securities fraud, are more prevalent, with an average annual pervasiveness of 41% (95% confidence interval between 30 and 55%) ... this estimate does not bode well for the US auditing system. In spite of all the regulation, roughly half of the US financial statements suffer of misreporting more serious than pure clerical errors.").

<sup>2</sup> See Daniel Aobdia, "The Effect of Audit Firm Internal Inspections on Auditor Effort and Financial Reporting Quality," *Accounting Review* (2022) (noting that internal inspections are "often" predictable).

<sup>3</sup> PCAOB Release No. 2022-006, at 24 ("We have observed situations where a firm's internal inspection procedures did not detect significant audit deficiencies or the firm did not make changes to address repeated identified audit deficiencies.").

<sup>4</sup> See PCAOB, *Spotlight: Staff Update and Preview of 2021 Inspection Observations*, December 2022 at 6 ("we aimed to increase the overall unpredictability of our inspections by including a higher percentage of random selections and non-traditional focus areas").

<sup>5</sup> See AS 2301.05.c (Incorporating elements of unpredictability in the selection of audit procedures to be performed).

despite concerns raised in PCAOB inspection reports about widespread non-conformity with the existing standards for CAMs disclosure.<sup>6</sup>

Despite repeated requests for disclosure from investors, the proposed standard also does not require disclosure of audit quality indicators (“AQIs”) that will allow investors and the public to assess the overall approaches by a firm to quality. The proposal does provide that any voluntary disclosure of AQIs must be accompanied by “reasonable detail” on “how the metrics were determined” and “how the metrics or the method of determining them changed since performance metrics were last communicated.” However, when voluntary disclosure is made to audit committees and “external parties,” investors and the public are likely to remain in the dark.

The PCAOB’s proposal also considered but declined to require disclosure of information to investors on the structure and operation of a firm’s system of quality control. As a justification for nondisclosure, the proposal pointed to the restrictions in the Sarbanes-Oxley Act on the PCAOB’s ability to reveal deficiencies in a firm’s system of quality control. The proposal asserted that the inability to disclose PCAOB identified deficiencies would result in disclosure that was “potentially incomplete” and “potentially misleading.”

We are concerned with an approach that would provide mandatory disclosure to audit committees (notwithstanding the limitations in the Sarbanes-Oxley Act) but not to investors and the public. We also are also concerned with the PCAOB’s proposed approach to disclosure that seeks to protect investors by keeping them in the dark. Rather than have regulators decide what information will benefit investors, U.S. securities laws favor disclosure so that investors can assess the relative importance of the information.

We also believe that investors will directly benefit from the disclosure of firm-identified deficiencies that omits PCAOB deficiencies. The proposal anticipates that the system of quality control will allow firms to proactively identify deficiencies before they appear in engagements. To the extent firms do not disclose any deficiencies to the public, particularly for larger firms over multiple years, investors may have concern that the system of quality control was not sufficient to proactively identify deficiencies. This would be useful information for investors.

Disclosure of deficiencies identified by firms will also encourage more robust approach to remediation. In adopting the Sarbanes-Oxley Act, Congress relied on disclosure to encourage remediation. For PCAOB identified deficiencies, the statute mandated disclosure if the deficiencies were not adequately remediated. The risk of disclosure, therefore, provided firms with an incentive to fix problems.

Self-identified deficiencies are not, however, subject to the mandatory disclosure regime in the statute. Thus, they lack the same incentive to remediate that is included in the Sarbanes-Oxley Act. By requiring mandatory disclosure in the standard, the PCAOB can restore this incentive.

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<sup>6</sup> PCAOB, Spotlight: Staff Update and Preview of 2021 Inspection Observations, December 2022 at 16 (“In 2021, we reviewed approximately 400 audits in which auditors were required to determine whether there were CAMs, and, if so, to communicate them in the auditor’s report. We identified deficiencies in approximately one-third of these reviews.”).

Firms will have an incentive to remedy issues to avoid repeating the same deficiency in successive years. The value of mandatory disclosure as an incentive to remediate can be seen with respect to broker-dealer audits where there is no disclosure of un-remediated deficiencies and deficiency rates remains stubbornly high.<sup>7</sup>

Mandatory disclosure with respect to quality control systems will also address a troubling gap in the PCAOB's existing disclosure regime for public accounting firms. In the Sarbanes-Oxley Act, Congress mandated that firms registering with the PCAOB include "a statement of the quality control policies of the firm for its accounting and auditing practices."<sup>8</sup> Firms furnish this information when registering, but the PCAOB does not require that this disclosure be updated. A single disclosure at the time of registration can quickly become out of date.

This is not consistent with the investor protection goals of the Sarbanes-Oxley Act. Providing the public with additional disclosure about a firm's quality control system will act as an updating function and better align PCAOB disclosure standards with what Congress intended.

### **III. Independence and Conflicts of Interest**

We believe that the PCAOB's quality control system standard must take a more proactive approach to the segregation of duties for audit quality and commercial interests.

Quality control can be expensive, reducing the profitability of public accounting firms at least in the short term. Quality control may result in the dismissal of a lucrative senior partner or a client. Quality control can also cause tension with clients, forcing engagement teams to make difficult inquiries or ask difficult questions. These issues illustrate the potential conflict between audit quality and the commercial interests of public accounting firms. For investors and the public to have trust in a system of quality control, there must be structures put in place that are designed to minimize or reduce these conflicts.

The PCAOB's proposal calls for "clear lines" of responsibility and supervision for audit quality but does not specify that those lines should include a separation of duties between those who are responsible for audit quality and commercial interests. Indeed, the proposal would place "ultimate responsibility" for quality control in the hands of the principal executive officer, the person likely responsible for ensuring the profitability of the firm, an approach that also would seem to preclude placing "ultimately responsibility" in the hands of independent directors on the board. The approach stops well short of what was recommended by U.S. Treasury Department's Advisory Committee of the Auditing Profession in 2008:

Recommendation 3: Urge the PCAOB and the SEC, in consultation with other federal and state regulators, auditing firms, investors, other financial statement users, and public companies, to analyze, explore, and enable, as appropriate, the

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<sup>7</sup> PCAOB, Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers, Release No. 2022-004, August 19, 2022, at 4 ("While inspection results over that period indicate that the quality of broker-dealer audit and attestation engagements has improved, the overall deficiency rates remain unacceptably high.").

<sup>8</sup> The Sarbanes-Oxley Act of 2002, Section 102(b)(2)(D), 15 U.S.C. 7212.

possibility and feasibility of firms appointing independent members with full voting power to firm boards and/or advisory boards with meaningful governance responsibilities to improve governance and transparency of auditing firms.<sup>9</sup>

The proposed standard's failure to require a separation of duties between audit quality and commercial interests is in sharp contrast to other areas of the federal securities laws. For example, credit rating agencies must structurally ensure that rating decisions are not influenced by commercial interests.<sup>10</sup> The Securities and Exchange Commission has brought enforcement actions when this separation was not maintained.<sup>11</sup>

The proposal does take one tentative step in this direction by proposing that firms auditing more than 100 issuers "should incorporate an oversight function for the audit practice that includes at least one person who is not a partner, shareholder, member, other principal, or employee of the firm and does 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." While this requirement is commendable, a single individual cannot guarantee meaningful independent oversight of audit quality.

One independent individual will often not be enough to influence audit quality, particularly when serving on a board or advisory council. The standard also does not require that the non-employee have any particular authority. In fact, the proposal expressly disclaims a need to include the individual within a firm's "chain of command." The proposal does not provide for disclosure with respect to the role of the non-employee, the definition used by the firm to ensure independence, or the selection process. Indeed, the proposed requirement is for the most part less than what the largest firms already have in place.

#### **IV. Additional Recommendations**

The PCAOB's proposal includes few specific references to audits of broker-dealers. Instead, the proposal for the most part relies on a principles-based approach that assumes systems of quality control will be adequately structured to address these audits. Yet the deficiency rate for audits of broker-dealers remains unacceptably high.<sup>12</sup> This suggests the need for more specific requirements with respect to audits of broker-dealers.

The proposal could specifically note the need for expertise in the conduct of broker-dealer audits, particularly with respect to regulatory requirements that are considered as part of the engagement. Similarly, broker-dealers associated with issuers are often subsidiaries. In these

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<sup>9</sup> U.S. Treasury Department, Advisory Committee on the Auditing Profession Final Report, October 6, 2008, at VII:8.

<sup>10</sup> See Securities and Exchange Commission Rule 17g-5(c)(8), 17 CFR 240.17g-5(c)(8).

<sup>11</sup> See *In the Matter of S&P Global Ratings*, Exchange Act Release No. 96308 (November 14, 2022), available at <https://www.sec.gov/litigation/admin/2022/34-96308.pdf>.

<sup>12</sup> PCAOB, Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers, Release No. 2022-004, August 19, 2022, at 4 ("While inspection results over that period indicate that the quality of broker-dealer audit and attestation engagements has improved, the overall deficiency rates remain unacceptably high.").

cases, the broker-dealer usually consists only of a portion of an issuer's operations. Auditors may need to consult with, receive information from, or rely on the procedures employed by, the auditor of the issuer. The proposal does not explicitly address how a system of audit quality will address this relationship. Finally, the proposal does not ensure that firms will take into account all relevant risks in conducting audits.<sup>13</sup>

Nor does the PCAOB's proposal provide for adequate supervision of the global networks that may be involved in a firm's system of quality control. These global networks may monitor engagements, provide tools, and mandate policies. The proposal recognizes this role by requiring firms setting quality objectives to address the role played by global networks.

The proposal, however, does not ensure that firms or the PCAOB can adequately assess or inspect the role played by these global networks. Global networks are not registered with the PCAOB. The PCAOB's ability to obtain information directly from firms' global networks will not always be possible.

Nor does the proposal ensure that firms will possess all relevant quality control information. Where a global network "performs monitoring activities related to a firm's QC system or its engagements," the proposal allows the firm to "request" certain categories of information from the global networks but does not require that the information actually be received. The standard should address this concern by limiting reliance by firms on global networks that are not registered with the PCAOB. Alternatively, the proposal could require that firms obtain written consent from global networks that would require the networks to provide any requested information relevant to quality control, either to the firm or the PCAOB.

The proposal also creates unnecessary risk on the part of the PCAOB by mandating notification to firms of third-party subpoenas. The proposal allows firms to "elect to request notification from the Board if the Board is requested by legal subpoena or other legal process to disclose information contained in Form QC" and states that the Board "will make reasonable efforts to honor such a request."

First, this provision is unnecessary. Firms can already request notification without specific authorization in the standard. Second, the commitment may interfere with investigations by other regulators and law enforcement. Subpoenas may be issued by federal agencies, federal criminal authorities, or state agencies. The commitment could effectively create an obligation to notify firms about such ongoing investigations even where regulators preferred otherwise.

Third, the commitment creates a potential ground for firms to sue the Board in the event notification did not occur. Any such suit would potentially involve discovery into the Board's rationale and create legal exposure for Board members. Fourth, subpoenaing parties may have an incentive to seek judicial orders prohibiting notification by the PCAOB, potentially involving the PCAOB in private litigation.

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<sup>13</sup> PCAOB Release No. 2022-006, at 83 ("For instance, a firm that conducts audits of brokers-dealers may consider information from relevant authorities, like the SEC and Financial Industry Regulatory Authority ("FINRA"), in identifying risks associated with such audit engagements.").

Finally, we are concerned that the proposed standard does not require that audit quality will be adequately considered at the time of the appointment of firm leadership. The proposal requires the establishment of quality objectives that will reinforce leadership's commitment to audit quality. With respect to the appointment of leadership, firms "may" but are not required to consider these objectives. This approach suggests that firms could in theory appoint leadership that had a demonstrated lack of commitment to audit quality. Needless to say, a commitment to audit quality should apply to both the appointment and the continuation of firms' leadership.

#### **IV. Conclusion**

The AFL-CIO strongly supports the adoption of rigorous quality control standards for audits of public companies and broker-dealers in order to protect the retirement savings of working people. Thank you for the opportunity to comment on the PCAOB's proposed quality control standard for public accounting firms. We very much appreciate the considerable work on the part of the PCAOB that went into this lengthy and thorough proposal. If I can be of further assistance, please contact me at (202) 637-5152 or [brees@aflcio.org](mailto:brees@aflcio.org).

Sincerely,

A handwritten signature in black ink, appearing to read 'B. Rees', with a stylized flourish at the end.

Brandon J. Rees  
Deputy Director, Corporations and Capital Markets