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Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006

Re: *A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms* (PCAOB Release No. 2022-006, November 18, 2022; PCAOB Rulemaking Docket Matter No. 046)

Dear Ms. Brown:

The U.S. Chamber of Commerce's Center for Capital Markets Competitiveness ("CCMC") appreciates the opportunity to comment on the Public Company Accounting Oversight Board ("PCAOB" or the "Board") Exposure Draft on *A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms* (the "Exposure Draft," the "Proposal," or "QC 1000"). Quality controls ("QCs") are foundational, as they provide an essential framework for effective audits.

The CCMC welcomes the effort by the PCAOB to update quality controls[1] as the current standards were promulgated by the American Institute of Certified Public Accountants ("AICPA") before the Sarbanes-Oxley Act of 2002 ("SOX").[2] Over the course of time, many changes have occurred in the financial reporting environment and the practice of public company auditing. Recently, audit firms, subject to PCAOB oversight, have invested substantial time and resources to achieve consistent, compliant, and effective implementation) of the updated global quality control standards of the International Auditing and Assurance Standards Board ("IAASB") on an *International Standard on Quality Management* ("ISQM 1") and have or are in the process of implementing the AICPA's *Statement on Quality Management Standards No. 1* ("SQMS 1").[3]

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[1] For example, see the letters to the PCAOB from the U.S. Chamber of Commerce Center for Capital Markets Competitiveness on the PCAOB Concept Release on *Potential Approach to Revisions to PCAOB Quality Control Standards* dated March 16, 2020; the PCAOB Request for Comment on *Advisory Groups – Draft Governance Frameworks* dated February 28, 2022; and the PCAOB Request for Comment on the *Draft 2022-2026 Strategic Plan* dated August 16, 2022.

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") added broker-dealer audits to the PCAOB's oversight responsibilities.

[3] Consistent with an AICPA commitment, ISQM 1 and SQMS 1 are substantially converged. The CCMC has long supported the convergence of PCAOB, IAASB, and AICPA auditing standards. Convergence is particularly important for quality control standards.

The CCMC appreciates the rationale the PCAOB has undertaken taken by proposing a quality control framework consistent with both ISQM 1 and SQMS 1. We believe that this is important for consistency and strongly support this approach. However, the Proposal significantly deviates from ISQM1 and SQMS1 by adding alternative, incremental, or prescriptive requirements. It is unclear why the Board exerted its discretion to do so as the changes are not based on any U.S. regulatory requirements or address any issues unique to U.S. capital markets.

Accordingly, we believe the Proposal fails to align in important respects with ISQM 1 and SQMS 1; it does not consistently maintain a principles-based approach to quality control standards; and as a result, we have concerns regarding the policy and potential operation of the Proposal.

Specifically, our concerns center on roles and responsibilities; special requirements for annually inspected audit firms, including independent board members; annual evaluation and reporting; and other matters. The next section briefly overviews the Proposal to provide context for our concerns which are detailed with more specificity below.

Overview

The Proposal defines an effective quality control system as one that provides a firm with reasonable assurance:

(1) *The firm, firm personnel, and other participants:*
   a. *Conduct engagements in accordance with applicable professional and legal requirements; and*

   b. *Fulfill their other responsibilities that are part of or subject to the firm's quality control system in accordance with applicable professional and legal requirements.*

(2) *Engagement reports issued by the firm are in accordance with applicable professional and legal requirements.*[4]

The Proposal provides a risk-based approach to the design, implementation, and operation of a firm's quality control system, allowing firms to proactively manage

[4] See the Exposure Draft, page A1-2.

the quality of engagements that it performs – whether audits, reviews, attestations, or other PCAOB-related engagements. The risk-based approach involves establishing quality objectives, identifying and assessing quality risks to the achievement of the quality objectives, designing and implementing quality responses to address the quality risks, and monitoring the firm's quality control system.[5]

The Proposal describes eight integrated components of a firm's quality control system: the firm's risk assessment process; governance and leadership; ethics and independence; acceptance and continuance of client relationships and specific engagements; engagement performance; resources; information and communication; and the monitoring and remediation process. The Proposal also includes requirements related to roles and responsibilities; evaluation of and reporting on the quality control system; and documentation of the quality control system.[6] The next section focuses on proposed requirements related to roles and responsibilities.

Roles and Responsibilities

The Proposal specifies that the firm's principal executive officer is ultimately responsible and accountable for the quality control system as a whole.[7] In addition, the Proposal requires the firm to assign the following roles and responsibilities with respect to the quality control system: (1) operational responsibility and accountability for the quality control system as a whole, (2) operational responsibility for the firm's compliance with ethics and independence requirements, (3) operational responsibility for the monitoring and remediation process, and (4) if appropriate based on the nature and circumstances of the firm, operational responsibility for other components of the quality control system.[8]

We understand that the fourth category may be intended to provide firms with flexibility in the assignment of roles and responsibilities. However, the eight components of a firm's quality control system are broad and can involve many firm personnel assignments. Accordingly, it is unclear what the PCAOB intends as to the assigned roles and responsibilities that would be encompassed within the fourth category. As discussed in greater depth later, this question takes on added importance for supervisory roles and responsibilities because of the proposed parameters for enforcement related to quality control.

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[5] See the Exposure Draft, page A1-1.
[6] See the Exposure Draft, pages A1-1 and A1-2.
[7] See the Exposure Draft, page A1-5.
[8] See the Exposure Draft, page A1-5.

Additionally, the Proposal includes various prescriptive aspects to the assignment of these roles and responsibilities, which likewise raise concerns. For example, the proposed standard uses the term "individual" in regards to assigning the required roles – which can have two meanings.[9] First, although it is not necessarily obvious from the wording in the proposed standard, the textual discussion in the Exposure Draft specifies that only one individual may be assigned responsibility for each of the required roles (1) through (3), and apparently even for roles in category (4).[10] Secondly, by using the term "individual" or "executive officer," the proposed standard notes that the person with ultimate responsibility need not be a single individual if the firm has co-principal executive officers, as the requirements would apply to each.[11]

ISQM 1 and SQMS 1 allow for ultimate responsibility and accountability, operational responsibility for the system of quality management, and operational responsibility for specific aspects of the system to be assigned to either an individual or individuals. ISQM 1 and SQMS 1 also provide for the assignment of ultimate responsibility and accountability for the system of quality management to the firm's chief executive officer, managing partner, or, if appropriate, the managing board of partners (or equivalent for each).[12]

The CCMC strongly encourages the PCAOB to adopt the approach in ISQM 1 and SQMS 1 and allow the assignment of quality control roles and responsibilities to either an individual or individuals. As it stands, the Proposal unnecessarily complicates the assignment of personnel, for both firms and individuals alike. The Proposal prescribes how firms must structure their operations and would force PCAOB registered audit firms around the world to change their organizational structures and assignments to a less suitable form given the firm's circumstances, including those based on jurisdictional and/or territory-specific considerations, while forcing firms to back track from the recently implemented ISQM 1 and SQMS 1. This also provides an illustration of how the proposed quality control standard may be prescriptive as to the organization and management of audit firms.

It should be noted that these prescriptive requirements in the Proposal are not focused on improving audit quality or enhancing audit effectiveness, and may cause harm to audit quality. If the Proposal is approved in its current form, the profession may face greatly expanded PCAOB enforcement activities against individuals in audit

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[9] See the Exposure Draft, pages A1-5 to A1-7.
[10] See the Exposure Draft, page 69.
[11] See the Exposure Draft, page A1-5.
[12] See the PCAOB *Comparison of Proposed QC 1000 with ISQM 1 and SQMS 1* (November 18, 2022), page 11.

firms, under a notion of "accountability," without any evidence of need, benefit, or other empirical support.

These points are acknowledged in the text of the Exposure Draft, which states:

> *... QC 1000 would impose specific responsibilities on the individuals assigned the specified roles, such that enforcement action could be brought against them individually if they fail to meet those responsibilities. Current QC standards generally impose responsibilities directly on the firm rather than on individuals. Enforcement actions related to the failure to comply with current QC standards can be brought against individuals for knowingly or recklessly contributing to violations by the firm or for the failure reasonably to supervise an associated person of the firm who commits certain violations. Under proposed QC 1000, the individuals who are assigned specific responsibilities with respect to the QC system could be charged with violations if they fail to comply with those responsibilities, as well as for knowingly or recklessly contributing to firm violations or failing reasonably to supervise. We believe that providing another basis for enforcement against responsible individuals could enhance their accountability for the QC system.*[13] (emphasis added)

Stepped up PCAOB enforcement, as envisioned under the Proposal, will sweep in the many individuals assigned to non-engagement roles that involve some component of a firm's quality control system. This will create uncertainty around the standards of conduct for individuals serving in these roles. For example, under the Proposal, individuals with supervisory responsibilities related to quality control would be subject to enforcement for "failing reasonably to supervise" in these capacities – whereby, even good faith actions could be subject to PCAOB enforcement.[14]

The CCMC does not support such an open-ended approach to enforcement. The PCAOB's existing enforcement tools are certainly adequate to achieve appropriate individual accountability.

Further, the Board's focus on enforcement may have unintended consequences that will have long-lasting adverse impacts upon the profession. Attracting and retaining high quality talent has always been an important priority for the profession. However, the historically tight labor market has made talent acquisition and retention an acute problem. This proposal may exacerbate these trends. For example, qualified

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[13] See the Exposure Draft, page 75.

[14] The Proposal adds conditions such as "timely" and "aware" related to quality control supervisory activities that likewise focus on accountability and expand enforcement opportunities.

individuals may be reluctant to take on quality control related roles. An aggressive enforcement atmosphere may create disincentives for individuals to join the profession, harming the talent pipeline that is necessary for the production of high-quality audits.

Across the country, universities, organizations such as the AICPA and the Center for Audit Quality, state societies and boards of accountancy, along with many others are working to enhance the attractiveness of the profession as accounting competes for talent with other types of businesses and organizations. One important objective is to overcome declining enrollments in university accounting programs. Given this environment, the Board's proposed approach to use quality control standards to elevate and expand PCAOB enforcement is particularly problematic.

Special Requirements for Annually Inspected Firms

The Proposal has three special "size-related" requirements. These special requirements involve having an independent board member, automating aspects of quality controls for independence, and monitoring in-process engagements. While it appears the largest audit firms already have these requirements in place, one or more of the requirements would be new for other firms. Our comments focus on the threshold for these special requirements and the requirement for an independent board member.

Threshold

Currently, a subset of both annually and triennially inspected audit firms are subject to some additional PCAOB requirements through their membership (prior to SOX) in the Securities and Exchange Commission ("SEC" or "Commission") Practices Section ("SECPS") division of the AICPA.[15] But, not all SECPS requirements applied (continue to apply) to every member firm. For example, SECPS requirements specified that only firms auditing more than five hundred SEC registrants needed to have an automated system to identify investment holdings of partners and managers that might impair independence.[16] As a result, the largest audit firms have automated

[15] According to the Exposure Draft, under PCAOB rules certain SECPS requirements still apply to 216 (about 13% of) PCAOB-registered firms, including 11 of the 14 annually inspected firms in 2022 (page 15). However, the Exposure Draft also discloses that 59% of the approximately 700 firms (about 413) registered with the PCAOB did not perform any issuer or broker dealer audits (or play a substantial role in such audits) in 2022 (pages 49 and 274). Thus, the SECPS requirements still apply to about 75% of the firms (216 of 287=75%, where 700-413=287) that perform audits (or play a substantial role). As an aside, registered firms that do not perform any issuer or broker-dealer audits (or play a substantial role) are not inspected by the PCAOB and would be subject to the design-only requirements of the Proposal.
[16] See the Exposure Draft, page 112.

independence systems that would comply with one of the special "size-related" requirements in the Proposal.[17]

However, the Proposal calls for significantly reducing the size-related threshold for applying the three special quality control requirements, which diminishes the scalability of the Proposal. The proposed threshold is registered firms subject to annual inspection by the PCAOB (i.e., firms that issue audit reports for more than one hundred issuers during the prior calendar year). This reduced "bright-line" threshold means that the special requirements would be new and costly to implement for annually inspected firms not subject to the SECPS requirements and auditing more than five hundred registrants (and/or annually inspected firms that have not otherwise voluntarily adopted them).

In addition, triennially inspected audit firms would need to anticipate reaching the threshold and implement all three of the size-related special requirements in advance. Doing so would be even more complicated under the circumstances of reaching the threshold through mergers or acquisitions of firms with issuer audit clients. Thus, the PCAOB's proposed requirements may serve as an impediment to audit firm mergers and acquisitions and otherwise perturb market activity.

Further, by increasing the costs of being an annually inspected firm, the proposed requirements could deter triennially inspected firms from accepting new public company audit engagements or encourage them to resign from existing audit engagements to avoid crossing the one hundred issuer threshold. Thus, the proposed requirements could be anti-competitive.

An added cost consideration with the proposed lower threshold is that the audit firms subject to annual inspection by the PCAOB can vary from year to year. Thus, not only would a triennially inspected audit firm need to anticipate reaching the one hundred issuer threshold and implement the special requirements in advance. But the audit firm could be forced to comply with the special requirements one year yet drop below the threshold and the need to comply in a subsequent year through resignation from or non-renewal of issuer audit engagements.

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[17] Relatedly, SEC Reg S-X Rule 2-01(d) provides that a firm's independence is not impaired solely because a covered person in the firm is not independent of an audit client, provided the covered person did not know of the circumstances giving rise to the violation, the violation was corrected as promptly as possible, and the firm maintains a quality control system meeting specified standards. Rule 2-01(d)(4) describes (for firms that provide audit, review, or attest services to more than 500 SEC registrants) features necessary for the firm's quality control system to meet the specified standards, which include an automated system to identify investment holdings of partners and managers that might impair independence (see the Exposure Draft, footnote 187 on page 113).

The CCMC urges the PCAOB to avoid imposing these costs and complexities. The CCMC strongly recommends that the PCAOB maintain the existing threshold of more than five hundred SEC registrants for any special "size-related" quality control requirements.

Independent Board Member

The Proposal requires that for firms issuing audit reports for more than 100 issuers during the prior calendar year:

> *[T]he firm's* ***governance structure*** *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 relationships with the firm that would interfere with the* ***exercise of independent judgment with regard to matters related to the QC system.***[18] (emphasis added)

The CCMC is concerned that this requirement lacks clarity, particularly as to what it means to be part of a firm's "governance structure…[in] an oversight function for the audit practice" and to "exercise independent judgment with regards to matters related to the quality control system." The lack of clarity creates a number of issues, including ones related to potential liability exposure for both firms and independent individuals; and it may contribute to an expectations gap among stakeholders.

We appreciate that the PCAOB intends to allow flexibility. Indeed, the text discussion in the Exposure Draft states that:

> *The requirements we are proposing would not specify how the firm would establish its governance structure or assign authority, other than having at least one person in an oversight role who would be in a position to exercise independent judgment with regard to QC matters.*[19]

However, the text discussion only adds to the lack of clarity and confusion over what the PCAOB intends.

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[18] See the Exposure Draft, page A1-11.
[19] See the Exposure Draft, page 98.

For example, the text discussion also states: "In 2021, we observed the largest six firms had some form of governance structure that included a non-employee."[20] Plus, the Economic Analysis section of the Exposure Draft adds that:

> *We believe there could be costs to design, implement, and operate the proposed oversight function. ... To help address these cost concerns, the proposed requirement would allow firms to implement an oversight function into their QC system which would be suitable for their circumstances. Costs, as well as associated benefits, could be attenuated for U.S. GNFs [global network firms] by the fact that all of the U.S. GNFs indicate, as of the 2020 inspection cycle, that they already have a governance structure that includes a non-employee.*[21]

These statements imply the PCAOB believes that all approaches taken by the largest six firms to obtaining independent input meet the requirements of the proposed standard, even though the approaches vary; they do not necessarily involve governing board membership; and – although focused on audit quality – they do not all involve any specific or formal oversight responsibility with respect to quality controls. For example, some firms have established audit quality advisory boards with independent members that function much like the PCAOB's Standards and Emerging Issues and Investor Advisory Groups; others have added one or more independent members to the board that oversees the strategic direction of the audit firm; and at least one firm, has done both.

Incorporating independent input on audit quality is a good practice, but the CCMC strongly supports giving firms flexibility in a principles based approach. The input of audit quality advisory groups with independent members can be more impactful than that of one independent member among many board members. Contractual and legal requirements (including jurisdictional considerations applicable to non-U.S. firms) may also constrain, complicate, or preclude adding an independent member to a firm's governing board.

Given these issues and our prior recommendation on threshold, the PCAOB could eliminate the independent "board member" requirement altogether. It would be unnecessary with the threshold for applicability raised to more than five hundred SEC registrants, as the PCAOB believes the largest six firms already voluntarily meet this requirement. Market forces would provide an incentive for any audit firm that exceeds the five hundred SEC registrant threshold in the future to likewise provide for

[20] See the Exposure Draft, footnote 163 on page 98.
[21] See the Exposure Draft, page 279.

independent input on audit quality matters, including those related to the system of quality controls.

If the PCAOB does not eliminate the requirement, the CCMC strongly recommends the PCAOB confirm that the intended meaning of "a firm's governance structure" encompasses audit quality advisory groups as currently constituted within the largest six firms. Therefore, these firms meet the proposed requirement – even though the independent members provide insights on quality control matters, but are not assigned any formal responsibilities for oversight or operation of the firm's quality control system, per se.

Evaluation and Reporting

Overview

The Proposal requires that all PCAOB registered and inspected firms annually evaluate the effectiveness of their quality control systems as of November 30th and report the results to the PCAOB by January 15th of the following year. The Proposal requires that the annual report to the PCAOB on a firm's evaluation of its quality control systems must be certified by both the individual assigned ultimate responsibility and accountability for the quality control system as a whole and the individual assigned operational responsibility and accountability for the quality control system as a whole.[22] In addition, the Proposal amends the PCAOB standard on audit committee communications to include a discussion with the audit committee on the conclusion of the firm's most recent annual evaluation of its quality control system and an overview of remedial actions.[23]

Specifically, the Proposal states:

> *Annually, the firm must evaluate the effectiveness of its QC system, based on the results of its monitoring and remediation activities, and conclude as of November 30th (the "evaluation date"), that its QC system is*

[22] See the Exposure Draft, page A1-6. The Economic Analysis Section of the Exposure Draft acknowledges a lack of empirical evidence supporting the benefits of this requirement. For example, the Auditing Standards Committee of the Auditing Section of the American Accounting Association ("AAA") recommended against it based on a review of academic literature on the impacts of similar requirements in the United Kingdom. The AAA committee concluded that "research does not provide compelling evidence that [mandatory] QC system certifications would add value." Nonetheless, the Exposure Draft states: "Based on our judgment and the absence of dispositive counterevidence in the academic literature, our preliminary view is that the proposed requirement would benefit investors" (p. 275). The PCAOB's view is despite that the certified audit firm annual quality control evaluation reports would not be publicly available to investors, in accordance with the provisions of SOX.

[23] See the Exposure Draft, page A5-17.

(a) effective with no unremediated quality control deficiencies; or

(b) effective except for one or more unremediated QC deficiencies that are not major QC deficiencies; or

(c) not effective (i.e., one or more major QC deficiencies exist).[24]

Certain definitions in the Proposal are relevant to understanding the proposed requirements for evaluating and reporting on the quality control system. For example, the Proposal defines a major quality control deficiency as:

> *An unremediated QC deficiency or combination of unremediated QC deficiencies, based on the [required] evaluation, that severely reduces the likelihood of the firm achieving the reasonable assurance objective* ***or*** *one or more quality objectives.*[25, 26] (emphasis added)[27]

The Proposal defines a quality control deficiency as:

> *A QC finding that, based on the [required] evaluation individually or in combination with one or more other QC findings, results in:*
>
> *(1) A reduced likelihood of the firm achieving the reasonable assurance objective* ***or*** *one or more quality objectives;*[28] (emphasis added)

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[24] See the Exposure Draft, page A1-34. An unremediated QC deficiency is one where remedial actions that completely address the QC deficiency have not been fully implemented, tested, and found effective.
[25] See the Exposure Draft, pages A1-39 and A1-40.
[26] In turn, the Proposal specifies conditions that would be presumed to indicate a major quality control deficiency. Presumptive conditions are an unremediated quality control deficiency (deficiencies) that (a) relate to the firm's governance and leadership that affect the overall environment supporting the operation of the QC system or (b) result in or likely to result in one or more significant engagement deficiencies in engagements that, taken together, are significant in relation to the firm's total portfolio of engagements (for example, because of the number of engagements or firm personnel affected or likely to be affected, the associated revenue or profit, the associated risks, or the relevant industry) (Exposure Draft, page A1-40).
[27] As subsequently discussed, the Proposal prescribes between (approximately) 34 to 48 different quality control objectives for six of the eight quality control system components and requires audit firms to determine additional ones based on the firm's facts and circumstances for these six components plus the other two components.
[28] The Proposal notes that: "The likelihood could be reduced if, for example, a quality objective is not established, a quality risk is not properly identified or assessed, or a quality response is not properly designed or implemented or is not operating effectively" (Exposure Draft, page A1-41).

> *(2) Noncompliance with requirements of this standard other than those under "Documentation;" or*
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> *(3) Noncompliance with requirements of this standard under "Documentation" that adversely affects the firm's ability to comply with any of the other requirements of this standard.*[29]

Another important distinction is that an engagement deficiency differs from a quality control deficiency. The Proposal defines an engagement deficiency as:

> *An instance of noncompliance with applicable professional and legal requirements by the firm, firm personnel, or other participants with respect to an engagement of the firm, or by the firm or firm personnel with respect to an engagement of another firm.*[30]

However, the Proposal specifies that engagement deficiencies are quality control findings, which, in turn, must be evaluated. The Proposal defines a quality control finding as a "finding about the design, implementation, or operation of the firm's QC system that may indicate one or more QC deficiencies exist."[31]

The Proposal requires firms to report annually to the PCAOB (on a newly proposed Form QC) the results of the evaluation (i.e., the conclusion) and, among other information, for evaluation conclusions involving options (b) or (c) above:

> *... a description of each unremediated QC deficiency, including each major QC deficiency, consisting of:*
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> *(1) The requirements of this standard or the quality objective(s) to which it relates;*
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> *(2) The firm's basis for determining it was a QC deficiency as of the evaluation date; and*
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> *(3) A summary of the remedial actions taken and planned to be taken to address the QC deficiency, as well as the timing and the status of such actions, including a summary of actions taken or to be taken by the firm*

[29] See the Exposure Draft, pages A1-40 and A1-41.
[30] See the Exposure Draft, page A1-39.
[31] See the Exposure Draft, page A1-41.

> *to address the risk that the QC deficiency resulted or could result in the issuance of unsupported engagement reports.*[32]

The CCMC is concerned about the complexity of the Proposal in evaluating and reporting on the quality control system. Moreover, under current PCAOB requirements and the inspection process, the PCAOB has access to any firm annual evaluation and conclusion without establishing a new reporting regime, including evaluations being conducted under ISQM 1 and/or SQMS 1. Likewise, auditor communications with audit committees currently involve relevant audit firm quality control information.

As discussed below, aspects of the proposed evaluation requirements and all the reporting requirements are unnecessary and unworkable. The costs of the proposed reporting and communication requirements far outweigh any benefits.

Annual Reporting is Unnecessary

It might be tempting to analogize that the requirements for audit firms to evaluate and report to the PCAOB on the effectiveness of firms' quality control systems are similar to internal control over financial reporting ("ICFR") requirements. In accordance with SOX Section 404 and SEC implementation rules, many public companies must annually assess the effectiveness of ICFR and disclose the results of this assessment, along with any material weaknesses in ICFR, in annual SEC 10-K filings. However, any such analogy is flawed.

The PCAOB's statutory authority and its inspection process under this authority, which results in inspection findings and conclusions on audit firm quality control systems, is unique to audit firms subject to PCAOB oversight. It has no corollary in ICFR or under SOX Section 404 for companies.[33]

SOX requires the PCAOB to conduct a continuing program of inspections to:

> *assess the degree of compliance of each registered public accounting firm and associated persons of that firm with the Act, the rules of the Board, the rules of the Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.*[34]

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[32] See the Exposure Draft, page A1-35.
[33] This is not to suggest that regulatory oversight in some industries, such as financial services, does not involve the regulated entity's internal controls, broadly defined, including operational controls and enterprise risk management.
[34] See SOX Section 104(a).

In conducting an inspection, the provisions of SOX include that the PCAOB shall:

> *evaluate the sufficiency of the quality control system of the firm, and the manner of the documentation and communication of that system by the firm; and*
>
> *perform such other testing of the audit, supervisory, and quality control procedures of the firm as are necessary or appropriate in light of the purpose of the inspection and the responsibilities of the Board.*[35]

Under the PCAOB's rules implementing SOX, Part II of PCAOB audit firm inspection reports discuss criticisms of, and potential defects in the firm's system of quality control. The PCAOB includes in Part II any deficiencies that an analysis of the inspection results – that is, the results from inspecting both the quality control system and individual audits – indicates that the firm's system of quality control does not provide reasonable assurance that firm personnel will comply with applicable professional standards and requirements.

In other words, the PCAOB already knows of and concludes on the existence of unremediated quality control deficiencies (which include "major" quality control deficiencies), communicates this conclusion to the audit firm, and describes the unremediated deficiencies.[36] The PCAOB reaches a conclusion, based on judgments of the PCAOB staff and Board, after considering all quality control findings, including engagement deficiencies, from its inspection process.[37]

Given the PCAOB inspection process, audit firm annual reporting to the PCAOB on the effectiveness of the firm's quality control system is unnecessary. It is of no meaningful incremental benefit to the PCAOB. The PCAOB's processes provide the Board and staff with any relevant, necessary contemporaneous quality control information. This is the case for both annual and triennially inspected audit firms, partly because of the on-going and continuous nature of Board remediation determinations as part of the PCAOB inspection process for all firms, as subsequently discussed. In addition, it is noteworthy that annually inspected firms auditing more

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[35] See SOX Section 104(d) (2) and (3).
[36] PCAOB inspectors use comment forms to document inspection deficiencies. These comments are shared with the audit firm even when a comment does not rise to a level of severity to be included in the audit firm inspection report.
[37] The PCAOB inspection process involves access to the results from an audit firm's internal inspection program and monitoring processes, peer reviews, and results from audit firm's annual quality control evaluations (conclusions) under ISQM 1 and SQMS 1. Thus, findings from these processes would be reflected in the PCAOB audit firm inspection reports.

than one hundred issuers audit approximately 99% of U.S. based market capitalization.[38, 39]

Annual Reporting is Unworkable

To appreciate why the proposed evaluation and reporting requirements are unworkable, it is helpful to describe some additional provisions of SOX and practical details of the PCAOB inspection process. Part II of PCAOB audit firm inspection reports (discussing criticisms of, and potential defects in a firm's system of quality control) are not publicly disclosed. Part II is confidential. SOX provides that:

> *... no portions of the inspection report that deal with criticisms of or potential defects in the quality control systems of the firm under inspection shall be made public if these criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report.*[40]

As a practical matter, Board determinations, as to whether Part II quality control defects have been satisfactorily remediated, are long delayed – well beyond 12 months after the date of the inspection report. To illustrate, recently the PCAOB posted various Part II findings from an annual inspection report dated more than four years ago, on inspections conducted more than five years ago, for audits and reviews performed more than six years ago.

One subtlety of this illustration is that the PCAOB continuously interacts with audit firms regarding PCAOB quality control findings and firms' ensuing remediation activities as it considers, in subsequent years, whether firms have satisfactorily remediated identified deficiencies. The inspection process, by its very nature, is a continuous one. There is constant interaction and flow of information between the PCAOB, and audit firms related to quality control matters and the remediation of identified quality control deficiencies – for both annually and triennially inspected firms.

However, this discussion of the PCAOB inspection process likewise reveals that the proposed reporting requirements would involve some significant challenges for

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[38] See "PCAOB Inspections and Large Accounting Firms," by Bryan K. Church and Lori B. Shefchick in *Accounting Horizons* (March 2012) and PCAOB Staff Inspection Brief on *Information about 2017 Inspections* (August 2017).
[39] These data undermine the cost-benefit justification for annual reporting by all PCAOB inspected firms based on information arguments related to triennially inspected firms (see the Exposure Draft, page 286). Any capital market consequences from the PCAOB failing to accelerate the timing of a triennially inspection would be very small indeed.
[40] See SOX Section 104(g)(2).

audit firms, which are insurmountable given the timelines inherent in the PCAOB inspection process and delays in Board remediation determinations.

These challenges are exacerbated by the fact that complex judgments pervade the application of quality control standards in the design, implementation, and operation of audit firm quality control systems. The inherent need for judgment, in conjunction with the pervasiveness of it, means that the proposed requirement for audit firms to annually report to the PCAOB on the evaluation of their quality control systems, including any unremediated quality control deficiencies, is ripe for second guessing by the PCAOB.

For example, the Proposal specifies quality objectives for six of the eight components of the quality control system.[41] The specified quality objectives number about thirty-four, although it would be about forty-eight if sub-parts are included in the count. Further, the Proposal requires audit firms to determine additional quality objectives for these and other components, based on a firm's facts and circumstances.

Similarly, complex judgments pervade identifying and assessing the quality risks to achieving the objectives, designing and implementing quality responses to address the risks, monitoring the quality control system, and the list goes on.[42] Differences in opinions on any of these myriad judgments could arise. Such differences could result in quality control deficiencies in the PCAOB's view, but not in the firm's view and, therefore, the deficiencies would not be reflected in the audit firm report to the PCAOB.

Terms such as engagement deficiency, quality control finding, quality control deficiency, and major quality control deficiency also involve significant judgments, regarding both existence and severity. These, too, provide much room for differences in views between audit firms and the PCAOB.

These are just illustrations of how judgment pervades the design, implementation, and operation of an audit firm's quality control system. Differences in views and healthy tensions naturally occur in this context without annual reporting;

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[41] See the Exposure Draft, page A1-8.

[42] From a conceptual standpoint, audit firm quality controls also differ from ICFR in this regard. ICFR risk consists of (1) the susceptibility to material misstatement of the financial reporting elements to which the controls identified relate, which also considers the materiality of the element and (2) the risk that controls will fail to operate as designed. Although assessing ICFR risk involves significant judgment, the concept of material misstatement of financial reporting elements gives these judgments a quantitative touchstone – in conjunction with qualitative considerations – which is absent from judgments on quality risks and audit firm quality controls.

but they get sorted out without compromising the process. However, the proposed requirement for annual reporting to the PCAOB, in conjunction with the Proposal's focus on accountability and enforcement, has the potential to create an adversarial dynamic that would not promote audit quality or well serve investor protection goals.

Other Considerations

Other aspects of the Proposed annual reporting requirement present significant challenges and concerns, including the required dates and deadlines, evaluation options, and confidentiality, which are discussed below.

Evaluation Date, Reporting Deadline, and Documentation Completion Date

For all firms, the Proposal prescribes an evaluation date of November 30th and a January 15th deadline for reporting to the PCAOB and completing all necessary quality control documentation. These arbitrary dates fail to appreciate that audit firms have different facts and circumstances that can influence the optimal timing for an annual quality control system evaluation, including different fiscal year ends. In requiring an annual evaluation of the quality control system, the CCMC strongly recommends that the PCAOB allow each firm to select its own evaluation date consistent with ISQM 1 and SQMS 1.

Although the CCMC strongly urges the PCAOB to drop the requirement for annual reporting to the PCAOB, we need to mention the problematic nature of January 15th as a filing deadline. It is a very short timeframe (about 45 days) that would not provide adequate time for firms to compile relevant information, including information on remedial actions. In addition, the November 30th to January 15th timeframe can encompass three federal holidays, several religious observances, possible periods of weather-related disruptions and includes the pressing year-end issues for audit firms and their clients. Further, the dates for reporting and documentation completion should not coincide so firms have additional time to complete the necessary documentation.

Evaluation Conclusion Options

The PCAOB proposed evaluation conclusion options, discussed above, differ from the conclusion options in ISQM 1 and SQMS 1. For example, the conclusion options in ISQM 1 (paraphrased) are that the system of quality management:

(a) Provides reasonable assurance that the objectives of the system of quality management are being achieved;

(b) Is effective, except for matters related to the identified deficiencies that have a severe but not pervasive effect on the design, implementation, and operation of the system of quality management; and

(c) Does not provide the firm with reasonable assurance that objectives of the system of quality management are being achieved [that is the identified deficiencies are severe and pervasive].[43]

The differences in options mean that audit firm evaluation conclusions could differ under the PCAOB's proposed requirements versus ISQM 1 (or SQMS 1). For example, the conclusion could be a "clean opinion" (option (a)) under ISQM 1 but an "except for opinion" (option (b)) under QC 1000 in circumstances where the firm has unremediated deficiencies that are not considered severe – which would create unnecessary complexity and confusion.

The CCMC views the conclusion options as an essential area for alignment of PCAOB, IAASB, and ASB requirements. The same facts and circumstances should give rise to the same conclusion, irrespective of the standard applied. We strongly urge the PCAOB to adopt the ISQM 1 approach, as it is a more reasonable one.

Confidentiality

As previously discussed, confidentiality constraints in SOX preclude disclosure by the PCAOB of audit firm quality control criticisms and potential defects in quality control systems (if timely remediated). The CCMC appreciates the Proposal provides that audit firm annual quality control reports to the PCAOB (on Form QC) would not be publicly available.

Nonetheless, the CCMC is concerned that the Exposure Draft indicates the PCAOB may publish Form QC information "in summaries, compilations, or other general reports" provided firms are not identified, unless the information has previously been made public by the firm(s) involved or by other lawful means.[44] We are not aware that the PCAOB has published this sort of information based on Part II

[43] See the PCAOB *Comparison of Proposed QC 1000 with ISQM 1 and SQMS 1* (November 18, 2022), page 72
[44] See the Exposure Draft, page 214.

inspection findings. The Exposure Draft also states that the PCAOB would disclose Form QCs if requested by legal subpoena or other legal processes.[45]

The CCMC is concerned that any such PCAOB publication or production of Form QC information would depart from the "spirit and letter" of the confidentiality provisions in SOX. This concern extends to any attempt to circumvent the confidential and privileged provisions in SOX Section 105(B)(5) on the use of PCAOB inspection documents.[46] Our concerns likewise encompass the increase in legal exposure for audit firms and individuals from PCAOB disclosure of any Form QC information.

These concerns are one more reason for eliminating the proposed requirement for annual quality control reporting on Form QC. The PCAOB should not use rulemaking to cause firms to disclose quality control matters that the PCAOB is prohibited by SOX from disclosing or cause firms to otherwise disclose information that would be confidential under statute.

Audit Committee Communications

The Proposal amends AS 1301, *Communications with Audit Committees,* to require the auditor to discuss with the audit committee the conclusion of the firm's most recent annual evaluation of its quality control system and a brief overview of remedial actions taken and to be taken.[47]

The CCMC is concerned that this requirement could violate the confidentiality constraints in SOX. Further, audit committees already have access to and receive significant information on audit firm quality controls under existing PCAOB standards,[48] audit firm (voluntary) annual reports on audit quality,[49] and other capital

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[45] See the Exposure Draft, footnote 286 on page 214.
[46] Essentially, SOX Section 105(B)(5) provides that except for the availability to certain government agencies (such as the SEC without loss of status as confidential and privileged), all documents and information prepared or received by or for the Board (and deliberations of the Board and its employees and agents) in connection with an inspection or investigation shall be confidential and privileged; shall not be subject to civil discovery or other legal process in Federal or State court or administrative agency proceeding; and shall be exempt from disclosure under the Freedom of Information Act or otherwise; unless and until presented in connection with a public proceeding or released in accordance with PCAOB disciplinary procedures.
[47] See the Exposure Draft, page A5-17.
[48] Quality control information audit firms currently provide is crafted to avoid undermining the confidentially provisions in SOX (see the Exposure Draft, footnote 312 on page 242).
[49] Audit firm audit quality reports often include a section on improvements the firm is making to its quality control system that can serve as a useful basis for discussions with audit committees.

market requirements.[50] Thus, the proposed requirement lacks any significant benefit. It is unnecessary and problematic.

CCMC Recommendations

To summarize, the CCMC is concerned about the complexity of the Proposal in regard to evaluating and reporting on an audit firm's quality control system. Moreover, aspects of the proposed evaluation requirements and all the reporting requirements are unnecessary and unworkable. Under current requirements and inspection processes, the PCAOB has access to a firm's annual evaluation, including the conclusions of the evaluation, without establishing a new reporting regime. Eliminating the quality control reporting requirements would result in no diminishment of the PCAOB inspection process or audit quality; having such requirements would not incrementally enhance the process or audit quality and could be detrimental to both. The costs of the proposed annual reporting requirements far outweigh any benefits.

We strongly urge the PCAOB to eliminate the requirements for annual reporting to the PCAOB and annual communications with audit committees from any final quality control standard. In addition, rather than impose a single date of November 30th on all firms for evaluating the effectiveness of their quality control systems, audit firms should be allowed to choose the appropriate date based on their facts and circumstances. CCMC also strongly recommends that the PCAOB adopt the evaluation conclusion options in ISQM 1 and SQMS 1.

Other Matters

Although the short comment period precluded an in-depth consideration of the Proposal, in this section, we discuss a few additional concerns on other matters, including definitions and selected requirements, audit market considerations, effective date, and inadequate comment period.

Definitions and Selected Requirements

At a foundational level, the CCMC is concerned about a lack of alignment in definitions between the Proposal and ISQM 1/SQMS 1. For example, as previously

[50] For example, requirements of the New York Stock Exchange, applicable to boards of directors of companies that have equity securities listed on the exchange, require that audit committees, at least annually obtain and review a report by the independent auditor describing (among other matters) the firm's internal quality control procedures; any material issues raised by the firm's most recent internal quality control review, peer review, or inquiry or investigation by governmental or professional authorities within the preceding five years; and steps taken to deal with any such issues.

noted, the Proposal specifies that engagement deficiencies are quality control findings. This specification is not included in ISQM 1 or SQMS 1, as clearly not all engagement deficiencies (such as an isolated instance of human error) rise to the level of a quality control finding. The CCMC strongly recommends that the PCAOB align the definitions of quality control findings and deficiencies with ISQM 1 and SQMS 1.

In terms of quality risks, the Proposal requires that for risks of intentional misconduct, the firm would only consider the likelihood that the risks would have an adverse effect on the achievement of its quality objectives. For all other risks, the firm would also assess the probability of occurrence in addition to assessing the probability of an adverse effect.[51] Thus, for intentional misconduct, firms would be required to consider risks that may have only a remote likelihood of occurring. Such an approach is not practical and may divert time, resources, and attention from what really matters for audit quality and audit effectiveness. The CCMC strongly recommends that the PCAOB reconsider this requirement. We suggest that quality risks be defined as "risks that individually or in combination with other risks, have a reasonable possibility of adversely affecting the firm's achievement of one or more quality objectives if the risks were to occur."

The Proposal imposes quality objective requirements for communication and information that would encompass all firm external communications (whether about the firm or engagement-level information) to external parties (whether company management, audit committees, boards of directors, regulators, or others). The CCMC is concerned about the breadth and scope of these requirements. For example, the requirements would include information not related to audit quality or audits performed in accordance with PCAOB standards. The CCMC strongly recommends that the PCAOB reconsider prescribing these quality objectives for information and communication.

The Proposal includes other participants within the scope of a firm's quality control system. The Proposal defines other participants as accounting firms, accountants, other professionals, and organizations (other than audit firm personnel) that assist with the performance of engagements or the design, implementation, or operation of the firm's quality control system, including engagement quality reviews.[52] This definition is not only inconsistent with ISQM 1 and SQMS 1, but very broad and seemingly unbounded. It sweeps in everything from network affiliates and other audit firms (with their own systems of quality control) to internal auditors that provide direct

[51] See the Exposure Draft, page 79.
[52] See the Exposure Draft, page A1-40.

assistance to the auditor. Further, the activities for most of these participants are already covered under other PCAOB auditing standards. The CCMC strongly encourages the PCAOB to reconsider the definition of other participants.

The proposed definition of an effective quality control system does not include policies and procedures,[53] yet they are embedded in various quality control system requirements.[54] Conceptually, there are two general types of policies and procedures: (1) those that provide for compliance with applicable professional and legal requirements and (2) those that a firm voluntarily implements beyond any professional or regulatory requirements to enhance audit quality and audit effectiveness. The CCMC is concerned that any inclusion of the latter within the scope of the Proposal – and, therefore, PCAOB accountability and enforcement – would provide a disincentive for firms to go beyond the requirements in PCAOB standards and, thereby, undermine investor protection.

Audit Market Considerations

As previously discussed, to the extent that the Proposal does not align with ISQM 1 and SQMS 1, it would impose additional costs on PCAOB registered audit firms – both one-time and continuing costs – which can be significant. Further, to the extent that the proposed requirements expand and facilitate PCAOB enforcement activities, significant costs (both direct and indirect) can be imposed on audit firms and individual auditors. These potential costs have attendant market effects.

The CCMC is concerned that the PCAOB has not fully considered the market effects of the Proposal, including anti-competitive aspects, the implications for market concentration, and the ability of U.S. audit firms to use global network affiliates. We strongly encourage the PCAOB to reconsider the proposed requirements from these perspectives.

For example, both U.S. and non-U.S. triennially inspected audit firms may decide that providing audit services (whether as lead auditor, in a substantial role, or in another role and whether part of a global network or not) is not cost effective, decline to provide such services, and deregister from the PCAOB. In turn, these decisions would have consequences for U.S. issuers, foreign private issuers, and broker-dealers, alike – regardless of whether their current audit firm is maintained or resigns. These consequences would include, but not be limited to, increasing audit fees, forcing auditor changes, and reducing the choice of audit firms.

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[53] See the Exposure Draft, page A1-2.
[54] For example, see the Exposure Draft, pages A1-13 to A1-16, A1-18, and A1-22 to A1-23.

Effective Date

The Exposure Draft states that the PCAOB is considering an effective date of December 15 of the year after approval by the SEC of a quality control standard adopted by the PCAOB.[55] We encourage the PCAOB to allow a full two years after SEC approval to implement the standard and amendments.

The scope, complexity, and consequences of the Proposal for all PCAOB registered and inspected firms worldwide, and regardless of size, along with any significant differences between a revised QC 1000 standard and ISQM 1/SQMS 1, will necessitate additional time to implement a final PCAOB quality control standard and related amendments.

Inadequate Comment Period

The PCAOB's Quality Control Proposal was preceded by a Concept Release in December 2019. After nearly three years, the Proposal was issued on November 18, 2022, just before the Thanksgiving holiday, with comments due by February 1, 2023. This comment period is inclusive of three additional federal holidays. Unanticipated and very difficult weather conditions around the country have also occurred since November.

The 75-day comment period is shorter than comment periods for most PCAOB proposed standards and rules (typically at least 90 days). Yet, the Proposal is one of the most consequential and complex proposals that the PCAOB has advanced for public comment. The Proposing Release runs to about 400 pages and supplementary materials consist of about 125 pages.

These factors raise due process concerns and have made it challenging for the CCMC to fully consider the Proposal and to develop our comments and recommendations. Our comment letter does not include all matters that we would address given adequate time to do so. These process concerns also impede the ability of the preparer community to fully understand the impact of the Proposal upon their operations and audit relationships.

Concluding Remarks

[55] See the Exposure Draft, page 290.

In conclusion, the CCMC believes that the Proposal in its current form may impose prescriptive requirements that will create a significant divergence from recently implemented global quality control standards. Such a divergence, combined with potential over-breadth of enforcement may degrade audit quality and harm the goal of investor protection. Our suggestions herein are designed to improve the Proposal and keep it in line with other relevant standards.

We are prepared to discuss our concerns and thoughts in greater detail and hope to achieve the goal of updating quality controls in a thoughtful and rationale manner.

Sincerely,

Tom Quaadman
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Center for Capital Markets Competitiveness
U.S. Chamber of Commerce