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Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

Re: Proposing Release: Firm and Engagement Metrics, PCAOB Release No. 2024-002, PCAOB Rulemaking Docket Matter No. 041,

Delivered via email to comments@pcaobus.org

Dear Secretary Brown:

Thank you for the opportunity to comment on your proposal for Firm and Engagement Metrics, PCAOB Release No. 2024-002, Rulemaking Docket Matter No. 041. I am a security analyst – a user of financial statements – who has followed accounting and financial reporting issues for most of my career.

The Firm and Engagement Metrics proposal is extensive, covering 11 areas. Its goal is to "provide additional information, context and perspective on auditor engagements, which could be used by investors, audit committees and other stakeholders," including the PCAOB, to better inform their decisions. This would presumably help to improve audit quality.

One obvious question is why now? As the proposing release notes, the idea for developing these metrics was originally proposed in 2008 by the U.S. Department of Treasury's Advisory Committee on the Auditing Profession, recommended by the PCAOB's Investor Advisory Group in 2013 and floated in the PCAOB's Concept Release on Audit Quality Indicators in 2015. Nine years have passed since the issuance of the 2015 concept release; so it seems highly unlikely that this Proposing Release can be viewed as simply a natural evolution of the original idea.

Instead, it appears that this proposal has surfaced to help to address a potential deterioration in audit quality, as evidenced most clearly by the high proportion of Part I.A and other deficiencies in PCAOB inspections over the past few years. PCAOB Chair Erica Williams has been vocal about this in the press, repeatedly calling the level of deficiencies "unacceptable."[1]

Consequently, I believe that this proposal should have been preceded by or included an analysis of the Part I.A and other deficiencies, conveying the PCAOB's own assessment of their causes and how the proposed metrics might help to alert stakeholders to problems at either the firm or engagement levels so that they might take action to address this problem. Every PCAOB

[1] https://tax.thomsonreuters.com/news/pcaob-chair-williams-rising-audit-deficiency-rates-are-unacceptable/

inspection report includes a listing of the most common Part I.A deficiencies, but does not offer an explanation of the likely causes of these failures, whether due to a lack of partner or manager involvement, staff inexperience, understaffing, sloppiness or others. While the PCAOB may not have conducted a formal analysis to determine the likely causes of these high audit deficiencies, it could have told us what it does know, perhaps offering anecdotal evidence from its staff as to the likely causes. This would have served to inform stakeholder assessments of the Firm and Engagement Metrics proposal to assess more accurately its potential benefits.

Media reports continue to assert that there is a shortage of accountants,[2] which could conceivably be at least a partial cause of the high proportion of audit inspection deficiencies. If this is so, then there may be a risk that adoption of proposed at this time could further tax the resources of independent public accounting firms, which could conceivably lead to an increase in deficiencies or a more widespread deterioration in audit quality. The proposal should have addressed this risk.

While I do not deny that the proposed metrics will help inform stakeholders about firm management and engagement effectiveness – Indeed, I learned some new things about firm practices just from reading the proposal – most of the measures, with the possible exception of the internal monitoring and restatement metrics, are indirect indicators of audit quality. (The release acknowledges and addresses this issue effectively, in my view.) There may be a positive correlation between the scores on firm metrics and the quality of audits conducted by that firm, but it is far from perfect. More importantly, even "good" metric scores on any particular engagement may not be indicative of a high quality audit.

Even when the engagement metrics indicate a higher risk that the audit is deficient, it is unlikely in my view that this will influence shareholder votes on auditor ratification. I am not aware of any instances where an auditor with high audit deficiency scores on inspections has either been replaced or has received a higher percentage of negative retention votes in proxies.[3] It would be useful to know whether the PCAOB has found any evidence of shareholders responding to the persistently high rates of Part I.A deficiencies.

Given the evolution and current structure of the investor/user community, only a small percentage of investors will likely benefit from the adoption of this proposal. The proposing release acknowledges that few retail investors will benefit from the data; but a significant percentage of institutional investors will probably not tap into it either. It is highly unlikely that index and ETF managers will devote any resources to following these metrics. Ditto for the proxy advisors. Fundamental investors are more likely to pay attention, but many are already stretched thin, both on the buy side and sell side. (I am not the only security analyst who has difficulty keeping up with all of the SEC filings produced by companies in my coverage list.) The indirect correlations of these metrics with audit quality will probably not provide a sufficient incentive for many fundamental investors to incorporate them into their work flows.

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[2] https://www.cpajournal.com/2023/12/01/the-accounting-profession-is-in-crisis/

[3] I am also not aware of any consideration given or actions taken by proxy advisors against accounting firms with high Part I.A deficiencies. If these advisors have not responded to multi-year, high Part I.A deficiency rates, are they likely to take action on firm and engagement metrics that are far more indirect?

Large institutional investment firms and certain fundamentally focused investors, such as hedge funds, are more likely to tap into PCAOB resources. Those who dig deeply into the financial statements may benefit from the supplemental input provided by the metrics. Likewise, one or two research providers that specialize in accounting and financial reporting issues may succeed in packaging their insights on auditing metrics for the benefit of institutional investors.

Ultimately, though, it is inefficient for investors to seek confirmation of audit effectiveness from resources outside of the financial statements and other SEC filings, such as proxies. Given unrelenting time constraints, most investors must make an assessment of audit quality through the disclosures provided in the financial statements, including auditors' opinions, reports on internal control, CAMs and critical accounting policies (and also the audit committee reports in proxy statements). These disclosures should supplement a comprehensive assessment of the quality of disclosures in the financial statements, footnotes and MD&A section.

The relevance of the metrics to investors is further challenged by the nature of the audit itself. While investors certainly want assurance against fraud and material misstatements, they also want to know that financial statements provide a reasonably accurate picture of enterprise performance. Audits may confirm that financial statements have been prepared in accordance with GAAP, but they do not tell us whether the policies and estimates chosen by management are aggressive or conservative. (Hence, the admonition in every audit opinion that the financial statements are the responsibility of management.) Audit opinions and processes do not tell us, for example, the risks of a future write-down or impairment. There are other ways to address these potential concerns – through CAMs, for example – but the record to date on CAMs has been disappointing, in my view.

If the Board does decide to adopt this proposal, the two engagement metrics that I believe are most relevant to investors are internal monitoring, as noted above, and also allocation of audit hours. Internal monitoring identifies previously completed audits that were selected for further review by the accounting firm. The disclosure would presumably be accompanied by a narrative explaining the cause of the selection and any ongoing efforts to address it. Allocation of audit hours can provide additional insight into key risk areas for the audit; but if the CAM disclosures were effective, disclosure of this metric would probably not be necessary.

Another metric that is not included in the proposal but is unquestionably the most relevant for investors is whether any previous audits have been deemed to have Part I.A or I.B deficiencies in PCAOB inspections. Section 104(g)(2) of the Sarbanes-Oxley Act restricts the PCAOB from disclosing Part II deficiencies (related to criticisms of or potential defects in the quality control systems of the accounting firm under inspection) unless such criticisms or defects are addressed to the PCAOBs satisfaction within 12 months of the date of the inspection report. There do not appear to be any restrictions, however, against the PCAOB from disclosing publicly the names of the companies whose audits have been deemed to have Part I.A or Part I.B deficiencies. (Part I.A deficiencies are those in which the accounting firm had not obtained sufficient appropriate audit evidence to support its opinions on either the company's financial statements or its internal control over financial reporting.)

To date (and in this proposal), the Board has not mandated this disclosure, despite periodic recommendations from stakeholders, including members of its Investment Advisory Group.

Presumably, the Board has not taken this step because these deficiencies have been addressed to its satisfaction within 12 months of the dissemination of the inspection reports. (I am not aware of any companies whose financial statements have been restated as a result of a correction of PCAOB-deemed audit deficiencies.)

Nevertheless, it seems highly likely public disclosure of engagement audit inspection deficiencies would obviate the need for most, if not all, of the proposed firm and engagement metrics. Adoption of a public disclosure rule could be delayed for several years to allow public accounting firms sufficient time to address the problems that have given rise to the high level of deficiencies in recent years.

In the meantime, the companies themselves have the option of disclosing the audit deficiencies voluntarily to their stakeholders. (Here too, I am not aware of any company that has chosen to do so.) The failure to disclose could conceivably be viewed as a breach of the Board of Directors' duty to shareholders, for the vast majority of Boards that ask their shareholders to ratify their appointment of their auditing firms each year.

If a company decides to go public with its audit inspection deficiencies, it would be appropriate, in my view, for the audit committee to instruct its auditor to make the disclosure in the auditor's annual letter(s), along with a (brief) explanation of the nature of the deficiencies and its remediation plans. The audit committee could then offer its response to the auditor's explanation in the audit committee report in the proxy statement to support its decision to recommend ratification of the appointment. Votes against ratification would probably increase, but the Board would be providing shareholders with an important disclosure that is relevant for the vote.

Although I have argued that the proposed metrics will probably be useful to only a small subset of investors, I believe that they have the potential to be quite useful to audit committees. It would be surprising if many audit committees are not already be using (or asking for) at least some of these metrics to gain insights into high risk areas of the audit and also assess the auditor's productivity (and gauge the reasonableness of their fees); but audit committees undoubtedly vary in their operating procedures and protocols, so those that are not already employing these metrics may find it useful to introduce them into their discussions with and evaluations of their public accounting firms.

While investors have little or no contact with auditors, audit committees have the advantage of direct access, which allows them to gain valuable context for these metrics. This should help to improve their own assessments about the quality of their company's financial statements and footnote disclosures.

Audit committees have a fiduciary duty to the company and its shareholders. They are required to monitor and oversee the financial reporting process for the benefit of shareholders. Yet, investors generally know little about their functioning. Most audit committee reports, included in annual proxy statements, are boilerplate and merely state that the committee has fulfilled its responsibilities, including discussing with the independent auditor the matters required by the PCAOB and SEC regarding the auditor's handling of various risks and its independence.

Because the audit committee reports are almost universally boilerplate, investors know little about the impact, positive or negative, of the audit committee on the company's financial reporting. The boilerplate approach gives the impression that nearly all audit committees act as a rubber stamp for management and the auditors. As representatives of the shareholders, audit committees have an opportunity, with the help of the proposed firm and engagement metrics, to communicate more about the audit process through their audit committee reports to add context to the numbers. This would be a useful service to investors, potentially reducing the need for them to attempt their own independent assessments (without the appropriate context). It could therefore enhance investor confidence about audit quality.

The PCAOB's proposal calls for the dissemination of the metrics publicly, through its own website. Among other things, it argues that public dissemination will facilitate peer group comparisons, enabling investors to better gauge audit quality. In the current financial reporting environment, however, in which most audit committees seem to approach their reporting as a check-the-box process, there is a risk that peer comparisons will become homogenized over time, making them considerably less useful to investors.

For that reason, I believe that it would be better for engagement metrics to be reported privately by external auditors to the audit committees that ask for them. (This proposal could then be reframed as a "best practices guide" for engagement level metric disclosures to assist audit committees in managing the financial reporting process.) Voluntary disclosures would potentially facilitate the future development of a true marketplace for enhanced disclosures, one that may reward companies who make more relevant and complete disclosures about their financial reporting practices with a lower cost of capital.

Likewise, as the PCAOB's proposal points out, most large public accounting firms are including similar firm level metrics in their audit quality and transparency reports. The proposal argues that these disclosures are not standardized across the universe of firms, but the PCAOB has considerable clout and should be able prod these firms over time as necessary to adopt standardized disclosures for the most important metrics.

To summarize: I believe that the Firm and Engagement Metric proposal is of limited benefit to users. As proposed, the metrics data is likely to be tapped by only a small percentage of users. To broaden the number of users potentially benefiting from the proposal, the PCAOB should encourage inclusion of the data directly in the SEC filings (e.g. financial and proxy statements).

Audit committee are likely to be the primary beneficiaries of the metrics, as the data will likely inform and enhance their discussions with their accounting firms. In the current reporting environment, however, public dissemination of the metrics will likely result in the homogenization of metrics among peers, which would reduce the value of these disclosures to audit committees and users. It would be better, therefore, to allow accounting firms to disseminate the data privately to their clients and give the audit committees some time to work with the data and hopefully produce disclosures that can inform users about the audit process and risk assessment. At the same time, however, I believe that the PCAOB should encourage companies to disclose audit inspection deficiencies (especially Part I.A deficiencies) to their shareholders to inform their decisions to ratify the appointment of their auditors.

Many accounting firms are now well on the way to developing and refining their firm metrics through their audit quality and transparency reports, even as they grapple with the challenges of reducing their high levels of audit deficiencies and seek to address staffing shortages. Adding a new and extensive set of disclosure requirements at this time, while they also devote resources to implement recently enacted and upcoming PCAOB standards (not to mention FASB standards) may add to their burden and further delay progress on addressing audit inspection deficiencies.

For all these reasons, I believe that it would be best to delay the adoption of this proposal (or scale it back considerably). This would allow the PCAOB to observe how the current firm metrics disclosures of the auditing firms and the transmission of engagement metrics to audit committees evolve. During this period, the use of firm and engagement metrics will hopefully be honed and the most appropriate and relevant disclosures for the benefit of users will emerge. If not, the PCAOB can step in later with a more refined proposal for mandatory disclosures.

Once again, I appreciate the opportunity to offer my thoughts on this proposal. I hope that you find them useful.

Sincerely,

Stephen P. Percoco