Comments of the Auditing Standards Committee of the Auditing Section of the American Accounting Association on the PCAOB's Proposal on *Firm and Engagement Metrics*

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Note: The views expressed in this letter are those of the participating members of the Committee and do not reflect an official position of the American Accounting Association. The comments do not necessarily reflect the views of every member.

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SUMMARY: On April 9, 2024, the Public Company Accounting Oversight Board (the Board or PCAOB) issued a request for comment on its proposal *Firm and Engagement Metrics* (PCAOB 2024a). This comment letter summarizes the views of the participating members of the Auditing Standards Committee of the Auditing Section of the American Accounting Association. We commend the PCAOB for its efforts to promote audit quality by emphasizing firm and engagement metrics. Based on our evaluation of the proposal, we offer some overall observations, key takeaways from academic research, and perspectives on the PCAOB's economic analysis.

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I. INTRODUCTION

The participating members of the Auditing Standards Committee of the Auditing Section of the American Accounting Association are pleased to provide feedback on the Public Company Accounting Oversight Board's (PCAOB's) proposal on *Firm and Engagement Metrics* (PCAOB 2024a). We want to commend the PCAOB for its efforts to promote audit quality by emphasizing the reporting of firm and engagement metrics. The below commentary summarizes the participating committee members' views of the proposal (PCAOB 2024a).[1]

Our comment letter is organized as follows: Section II offers overall observations on the proposal; Section III presents key takeaways from research; Section IV discusses perspectives on the PCAOB's economic analysis; and Section V provides a conclusion to the comment letter. We present responses to select questions posed in the proposal in Sections III and IV.

II. OVERALL OBSERVATIONS

Problem Definition

The proposal argues that disclosure of firm metrics will promote auditor accountability. With (a) CPA licensing, (b) PCAOB registration, standard setting, inspections, and enforcement, and (c) SEC oversight and enforcement already in place and functioning quite robustly, public company auditors already are held accountable through a level of regulation and scrutiny never before seen in the U.S. It is unclear whether disclosure of firm and engagement metrics will meaningfully increase auditor accountability beyond the existing sources of accountability. Therefore, what is the underlying problem that this proposal is trying to solve?[2] We encourage the

[1] We use or adapt certain language from the PCAOB (2024a) proposal throughout our response.
[2] We also discuss this issue in more depth in Section IV.

PCAOB to fully and precisely articulate the incremental contribution to auditor accountability provided by this slate of disclosures.

The proposal also asserts that the disclosure of the proposed metrics will enable "stakeholders to make better-informed decisions" (p. 3). A broad philosophical question that arises from this proposal and other PCAOB efforts is, "Are we headed toward knowing more about public company auditors than we know about issuers?" As we consider the specific metrics required in this proposal (hours, turnover, focus of work, internal ratings, etc.), do we have similar information about issuers, even at the company level? We clearly do not have such information about issuers at the project level, which would be analogous to the engagement level for firms. Ultimately, investors put their money into issuers, with auditors serving an important role in providing credibility to issuer information. When considering current and future PCAOB proposals, it may be helpful to consider how much information investors will have about issuers versus auditors.

Evaluation Criteria

The proposal includes several specific firm and engagement metrics and extremely detailed guidance about calculating the metrics. It seems apparent that relevant firm and engagement metrics could change over time. For example, it is possible that future metrics of interest could include the proportion of an audit conducted with the assistance of artificial intelligence (AI) or the proportion of audit work done remotely versus on-site (Barnes and Hermanson 2023; Fotoh and Lorentzon 2023).

Since the precise metrics to be used may evolve and there are many current possible metrics to consider (e.g., Bedard, Johnstone, and Smith 2010; Knechel, Krishnan, Pevzner, Shefchik, and Velury 2013; Christensen, Glover, Omer, and Shelley 2016), we encourage the PCAOB to develop evaluation criteria for determining the relevant metrics and an appropriate medium to report those

metrics. We believe that the following criteria could serve as a starting point and could be applied to the currently proposed metrics:

1. Is the metric's relation with audit quality unambiguous? Can the metric be appropriately interpreted on its own, without additional context (e.g., client mix or complexity – size, industry, international operations; firm's audit approach; etc.)?[3]

2. If disclosure of the metric results in behavioral change in audit firms, does research suggest the change will improve audit quality or, at least, not adversely impact audit quality?

3. Will the metric require firms to develop systems, processes, and procedures that they do not already have?

4. Will the metric impose ongoing administrative burdens on engagement teams that result in a reallocation of effort away from audit quality enhancing activities?

Unintended Consequences

Disclosure of the proposed firm and engagement metrics may have unintended consequences. First, there is an incentive for audit firms to "manage" these metrics similar to how companies engage in earnings management. Accounting research over many decades examines management's efforts to manage earnings, even to the level of committing fraud (e.g., Beasley, Carcello, and Hermanson 1999; Graham, Harvey, and Rajgopal 2005; Beasley, Carcello, Hermanson, and Neal 2010; Dichev, Graham, Harvey, and Rajgopal 2013; Grandstaff and Solsma 2021). With public disclosure of audit firm and engagement metrics, the PCAOB needs to fully recognize the potential for significant "earnings management" type behavior by auditors and audit firms regarding these metrics, especially those that are disclosed publicly.

Improvement in particular metrics might be due to positive behavioral changes in audit firms, which is the intent of the proposal. However, improvement also could be due to opportunistic management of certain measures. For example, auditors could subtly encourage

[3] We discuss this evaluation criterion in more depth in Section III, including the usefulness of univariate measures (simple percentages or means).

junior or non-expert auditors to "eat" or reallocate time in an effort to make certain metrics appear more favorable. Unintended consequences need to be carefully considered as auditors balance misstatement risk, audit risk, business risk, client retention risk, PCAOB inspection risk, PCAOB enforcement risk, and now PCAOB disclosure risk. Any time a party produces information that is used to evaluate or punish that party, there is some risk of intentional misstatement.

Disclosure of firm and engagement metrics also might change behavior in ways that are harmful to audit quality. For example, processes related to quality performance ratings, compensation, and internal monitoring (that currently are in-house only) may change once auditors know that the results will be made public at the firm level. It is possible that ratings of various types could become less rigorous and less useful in promoting audit quality once they are publicly disclosed.

Use of the Disclosures

The public release of audit firm and engagement data undoubtedly would be wonderful for auditing research. It is probably not an overstatement to say that such data could drive 25 years of academic research, and such research is likely to provide important new insights into the audit process and factors associated with audit quality. Researchers have struggled to obtain such data in recent years, and this proposal could ignite a *Renaissance* in auditing research.

Beyond the use of the disclosures by researchers and other parties who might analyze and summarize the data (along the lines of current efforts by Audit Analytics to synthesize auditor-related data), there is experimental evidence that investors respond to positive versus negative trends in audit quality indicators and that providing context is meaningful to investors (Brown and Popova 2019). However, the granularity of the proposed firm and engagement metrics makes us less certain about the degree to which the new disclosures will be used, especially if they are not

trending positive or negative as in Brown and Popova (2019). The notion that, for example, a financial statement user or retail investor will dig down to the level of pre-year-end versus post-year-end audit hours at the engagement level seems a stretch to us. Moreover, it is unclear *how* a financial statement user or retail investor would interpret this information, especially when the relation between the metric and audit quality is ambiguous and/or context-dependent.

The data set that would be produced under this proposal is massive and requires an adequate understanding of context. Financial statement users have limited time and audit expertise to do so. Even audit committee members may rely more on their personal interactions with the auditor to assess audit quality than they would rely on this new database, which is proposed as an important resource for them. Ultimately, investor and audit committee use and interpretation of a large database of very detailed disclosures are empirical issues.

We also believe that it is important to consider uses of these metrics, especially at the engagement level, that may be unintended or even nefarious. For example, could management of an issuer gain a better understanding of their auditor's testing approach through these metrics, such that management's opportunity or capability to manipulate results or even commit fraud is enhanced (Wolfe and Hermanson 2004; Hermanson and Wolfe 2024)? Knowing how and where the auditor spends time could aid management in trying to circumvent auditor testing, reducing audit quality.

As another example, could a competing audit firm use these metrics to identify new client "targets" and attempt to compete not on higher audit quality, but on lower cost? A competing firm could observe what they view as overly top-heavy audits or audits with "too much" time spent in higher-risk areas. Such a firm then could seek to attract such clients with a pitch of, "Your current

auditor is really overdoing it—we can provide a much more cost effective, but still quality, audit." Situations like this would lead to reduced audit quality, on average.

Overall, we encourage careful consideration of who will use these disclosures, and how they might be used in unintended or nefarious ways. Pulling back the veil on the auditors, especially at the engagement level, may not always positively contribute to audit quality. Part of the advantage that an auditor has is management and others not knowing too much about what the auditor is doing.

Costs and Smaller Firms

The costs of generating this information, including auditor distraction from the performance and review of audit procedures and evaluation of results, may be quite significant. We especially wonder about the differential impact on small and medium firms and the ultimate effect on audit market concentration, especially when considering this proposal is in combination with PCAOB efforts on noncompliance with laws and regulations (PCAOB 2023) and many other PCAOB efforts. Overall, as the regulatory burden on public company auditors increases, more and more small and midsized firms may exit public company auditing completely, leaving primarily the top 8-10 firms.

We further discuss the influence of the proposal on small and medium-sized firms in Section III, and we further discuss our concerns related to the cost issue in Section IV. Notably, we are concerned that the cost analysis is inconsistent, imprecise, and incomplete because the proposal is missing evidence and numerical analysis to support the need for the rule or the baseline for measuring its impact.

III. KEY TAKEAWAYS FROM RESEARCH

In this section, we present comments and feedback based on findings from research, and we also present responses to select questions from the proposal.

Usefulness of the Firm and Engagement Metrics for Investors

Question 1: Would the proposed metrics, individually or collectively, provide useful information for investors, audit committees, or other stakeholders? Why or why not? How would stakeholders use the metrics?

In our comments, we will focus on the usefulness of the information for investors. In evaluating whether the proposed engagement and firm metric disclosures could be helpful to investors in making better decisions, it is important to first establish criteria that can be used in this evaluation. Building upon evaluation criteria discussed in Section II of this comment letter, we believe the following statements are useful to consider:

1. One of the self-stated goals of the SEC is to: "Modernize design, delivery, and content of disclosures so investors, including *in particular retail investors*, can access consistent, comparable, and material information to make informed investment decisions" (SEC 2023, emphasis added).

2. Acting Chief Accountant Paul Munter said that "The basic premise of this disclosure-based regulatory regime is that if investors have timely, accurate, and complete financial and other information, they can make informed, rational investment decisions" (SEC 2022).

Based on these statements, we encourage the Board to evaluate the potential usefulness of the proposed firm and engagement metric disclosures against criteria such as consistency, comparability, timeliness, accuracy, and completeness, with the goal of determining whether such disclosure can help retail investors make informed and rational investment decisions. We focus in particular on retail investors because (1) the SEC has stated that required disclosures are particularly meant to help that investor group as opposed to institutional investors and (2) audit committees have their own avenues to obtain arguably more detailed information outside of

regulated disclosures. If data related to a proposed disclosure does not substantially accomplish the disclosure-related objectives discussed above, then it is unclear whether the individual disclosure should be required.

We applaud the PCAOB and the Office of Economic and Risk Analysis for their thorough review of the academic literature to cite dozens of studies that examine the link between aspects of the proposed disclosures (e.g., auditor workload) and audit quality.[4] This proposal was undoubtedly a herculean task, and this letter does not dispute the results of those studies. However, it is unclear whether those studies can be used as support for the proposed disclosure of *univariate statistics* (i.e., simple percentages or means) about engagement and firm metrics. The studies cited utilize statistical methods to hold all else constant such that a single regression coefficient or experimental cell mean can be interpretable in something close to a causal relationship. Even if academic studies link these metrics with aspects of audit quality, it is not a given that the univariate statistics of the proposed engagement and firm metrics can be interpreted in a consistent, comparable, accurate, or complete way such that investors could rely on the data individually to make informed and rational decisions. While we acknowledge that the proposed form would permit firms and engagements to provide additional information in a "context box," we question whether such information could provide sufficient context behind a 10,000+ hour audit.

We acknowledge that the proposed standard does list potential misinterpretation of data as an unintended consequence; however, it was not included as a potential cost of the proposed disclosure. Indeed, the cost of this misinterpretation would likely be borne by those the PCAOB

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[4] We acknowledge that the proposal no longer calls these proposed disclosures "audit quality indicators" as done previously. However, the proposal is clear that it hopes these disclosures are useful to investors, audit committees, and other stakeholders in their efforts to distinguish between auditors, such that auditors can be held more accountable for poor delivery of the audit. Thus, while not called audit quality indicators, these proposed disclosures are presumably discussed because of their ability to signal the quality-related aspects of the audit firm/engagement.

and SEC are most charged to protect—investors—as they would be at most risk of using potentially misleading univariate statistics to make their investment decisions.

In the end, in considering the question of whether the proposed information could potentially help investors make better decisions, we urge the PCAOB and the SEC to critically, carefully, and objectively evaluate the proposed disclosures against questions such as these (also see Section II above):

- Do the proposed univariate disclosures meet the SEC goals for required disclosures?
- Will disclosure of this univariate information be done in a consistent manner?
- Will the univariate disclosures result in comparable information and comparable interpretation of that information across complex engagements and firms?
- Will the univariate disclosures provide a complete picture of the engagement and firm?
- Will the disclosures of univariate statistics help *retail investors* make informed and rational investment decisions?

It is unclear whether the answer to most of these questions (and other similar questions) is a resounding "yes" given the inherent complexities of the public company audit. In fact, page 6 of the proposal acknowledges that drafters of the proposed standard agree with our concern: "For some of our proposed metrics, numerical values may provide different signals in different contexts." Further, page 27 acknowledges that "engagements differ based on the size of the engagement, the industry of the company, the risks related to the company and the audit, whether it is a new engagement for the firm, or there has been a change in the engagement partner. This lack of standardization across both firms and engagements makes the task of comparison difficult." We encourage the PCAOB to focus on disclosures that individually meet the criteria discussed earlier. Alternatively, we encourage the PCAOB to discuss and provide evidence of how the disclosure of multiple metrics together can meet those criteria collectively even if not individually.

Will Investors Use the Firm and Engagement Metrics?

As previously noted, Question 1 of the proposal asks, "How would stakeholders use the metrics" provided in the proposed disclosures by audit firms. The proposal aptly acknowledges, and we agree, that supply-side (auditor willingness to disclose) and demand-side (investor appetite for additional disclosure) factors influence the proposed use of mandated disclosures. Particularly for investors, the focus is on the acquisition costs required to obtain the private information about audit firms that would now be publicly available. The proposal suggests that the potential "benefits of the information to an individual investor would be dissipated because all other investors would have the same information and any informational advantage would be lost" (p. 131).

The proposal states (p. 136), "In addition to mandating disclosure, the proposal would also specify the data sources and calculations for each proposed metric and require their disclosure in PCAOB forms in an electronic, structured data format." Some prior research suggests there is an appetite among investors for more information on the inputs to and the production of audits, such as training, internal inspection findings, and the frequency of consultations between engagement teams and their national office (e.g., Christensen et al. 2016). To some degree, investors and auditors perceive these factors as audit quality indicators. However, prior research suggests there is mixed evidence on the influence of Form AP disclosures on investor decision-making (e.g., Burke, Hoitash, and Hoitash 2019; Cunningham, Li, Stein, and Wright 2019; Doxey, Lawson, Lopez, and Swanquist 2021; Pittman, Stein, and Valentine 2023). Form AP is one proposed location for some of the auditor-specific metrics in the proposal. Form AP offers some information not otherwise publicly available or provided in a centralized location.

The archival academic literature in accounting finds that investors indeed react to audit outcomes (e.g., restatements, audit failures, disclosure of internal control material weaknesses),

auditor behavior (e.g., breaches of the PCAOB inspection process), and regulatory-induced disclosures in the audit report (e.g., modified audit opinions, critical audit matters), but this research is nuanced and context-specific (e.g., Knechel et al. 2013; DeFond and Zhang 2014).

Consistent with the SEC's goal of aiding retail investors, experimental accounting literature provides evidence of non-professional investor reactions. This research on investor reaction to similar audit outcomes, auditor behavior, and regulatory changes (e.g., disclosure of auditor tenure, partner identification) finds mixed results (e.g., Carey and Simnett 2006; Beck, Fuller, Muriel, and Reid 2013; Elliott, Hobson, and White 2015; Christensen et al. 2016; Rapley, Robertson, and Smith 2021; Judge, Goodson, and Stefaniak 2023).

While we agree that understanding whether and how investors use information regarding the inputs and production of audits is important, a related question is whether this increased disclosure leads to information overload (e.g., Schick, Gordon, and Haka 1980; Chewning and Harrell 1990). Individuals, including investors, have limited processing power (e.g., Simon 1986; Dietrich, Kachelmeier, Kleinmuntz, and Linsmeier 2001) relative to the ability of groups (e.g., Stocks and Harrell 1995). As the number of information cues increases, investors may not fully incorporate all audit-related disclosures into their decision-making process. They may focus more on certain types of information (e.g., audit opinions) while overlooking other details (e.g., explanations of accounting policies or internal control issues) (e.g., Chewning and Harrell 1990; Knechel et al. 2013; DeFond and Zhang 2014).

Little research in auditing exists to help evaluate whether more is better. The dearth of literature presents an opportunity for both researchers and the PCAOB (and other standards setters) to quantify the impact on investors and other stakeholders of increased auditor-specific disclosures. Additional academic research and further economic analysis, later discussed in this comment

letter, would be useful in helping to prioritize which of the myriad proposed metrics most increases the decision usefulness of these disclosures.

This need for more research and economic analysis notwithstanding, we offer insights from the broader research on disclosure in financial reporting (e.g., in the annual report). For example, this research suggests that disclosures induced by regulation initially enhance decision quality of stakeholders, including analysts (e.g., Impink, Paananen, and Renders 2022), bank loan officers (e.g., Casey 1980), and investors more generally (e.g., Tuttle and Burton 1999). Above a certain level of disclosure, however, these increases in disclosures *decrease* decision quality (e.g., Chewning and Harrell 1990; Impink et al. 2022). As the proposal suggests, this research also finds that experience and access to information negatively impact decision quality (e.g., Clement 1999; Miller 2010; Impink et al. 2022). These findings are consistent with information overload and suggest that in the financial reporting context, increased disclosure in annual reports has resulted in unintended consequences for financial statement users (e.g., Botosan and Harris 2000; Campbell, Chen, Dhaliwal, Hu, and Steele 2014), decreasing a key characteristic of financial reporting—its decision usefulness (FASB 2010).

The accounting and auditing research underscores the importance of audit quality, transparency, and regulatory oversight in shaping investor perceptions and behaviors. Understanding how investors process auditor-provided information can inform the proposal on the number, purpose, and other characteristics of the proposed auditor metrics. Our comments above also offer suggestions for how to improve the description of the problem and how the proposal could address it (Question 92), additional relevant literature, particularly on information overload (Question 93), and a discussion of how the cited research could inform the analysis (Question 94).

Impact of the Proposal's Reporting Requirements on Smaller Firms

We applaud the PCAOB for recognizing and seeking comments on the potential impact that this proposal will have on smaller firms. In recent PCAOB standard setting activities, the Board has also made concerted efforts to address the scalability of new standards for smaller firms, including most recently during the March 2024 public roundtable for the PCAOB proposal for *Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments* (PCAOB 2024b). Notably, in the current proposal, the Board presents multiple questions that seek feedback on the potential impact of the proposal on smaller firms. For example, Question 2 asks, "Are any of the metrics we are proposing overly focused on the operations of larger firms," and Question 65 asks, "Should smaller firms have different reporting requirements than larger firms? Why or why not?" We also acknowledge additional questions that seek feedback on the proposal's impact on smaller firms. Further, in Board member Christina Ho's comments about the proposal, she further addresses the interests of smaller firms as she looks forward to "hearing about the impact on small and medium firms" (PCAOB 2024c).

In our comments, instead of addressing each specific question posed about smaller firms, we offer a broader commentary regarding the potential impact of the proposal's requirements on smaller firms. Collectively, based on our discussion below, we believe the PCAOB should carefully consider and address the impact of these new requirements on smaller firms by considering an increase in the reporting threshold to allow for a competitive marketplace that includes small and midsized audit firms.

We first encourage the PCAOB to consider that larger firms are at a comparative advantage versus smaller firms regarding the implementation of the proposal's requirements. As the proposal

acknowledges, most of the larger firms are already well positioned with established systems to collect and aggregate the required metrics, whereas smaller firms are unlikely to have systems in place. We address costs and benefits in more detail below, but it is clear that the smaller firms will incur significant startup and ongoing costs and, despite being better positioned, even the larger firms will incur some new and ongoing costs with changes that will likely be needed to adapt their existing systems. The public press has documented larger firms' willingness and, more importantly, ability to make extensive investments (in the billions) in advancing new technologies (e.g., EY 2022; KPMG 2023; PwC 2023a; Deloitte 2024). Therefore, not surprisingly, academic research finds that firm size appears to be the critical factor in firms' ability to adopt and implement new systems and technologies (e.g., artificial intelligence, machine learning, robotic process automation, etc.) (Bakarich and O'Brien 2021; Barr-Pulliam and Carlson 2024). Within the context of tracking and aggregating firm and engagement-level metrics, developing systems with innovative technologies provides the opportunity for even greater competitive advantages and efficiencies for larger firms.

We next encourage the PCAOB to consider how the proposal could impact audit quality for smaller firms. Without existing systems in place and fewer available resources to create new and efficient systems, as discussed above, the implementation of systems and tracking of the various metrics could detract from audit quality for smaller firm auditors. For example, research shows that auditors already believe the current environment with PCAOB inspections creates more fee pressures due to over-documentation, and too much attention on auditing standards to the detriment of focusing on the accounting (Westermann, Cohen, and Trompeter 2019). Moreover, Persellin, Schmidt, Vandervelde, and Wilkins (2019) find that auditors believe that audit quality is already at risk due to staffing shortages and deadline pressures. The proposed standard will likely

place more fee pressure and documentation burdens on smaller firms, potentially exacerbating these issues. With the Big 4 firms already auditing over 88 percent of the large accelerated filers and with research showing that the population of smaller audit firms (firms with less than 100 clients) decreasing by over 50 percent in recent years (Liu and Simunic 2005; DeFond and Lennox 2011; Ryan 2022; Christensen, Smith, Wang, and Williams 2023), the significant pace of newly proposed PCAOB regulations (e.g., PCAOB 2023) continues to introduce greater market concentration risk. It, therefore, becomes more likely that smaller firms will not have the resources to adapt to all of the new standards, including the current proposal, and may decide to leave the industry. As discussed by former PCAOB board member, Steven Harris (2017), the potential for greater overconcentration creates additional risks to audit quality and the capital markets.

Next, there are risks to audit quality related to the ongoing pipeline crisis for accountants (AICPA 2022; Foley 2022). A robust and talented workforce is needed for high quality audits. With the recent growth in new regulatory burdens, including the reporting requirements in this proposal, an unintended consequence is creating a profession that becomes less attractive to business students deciding on a college major or to practicing, talented professionals who can choose to leave their firm. Smaller firm auditors, who have resource limitations, will need to spend more time complying with these requirements than larger firm auditors and, consequently, less time providing high quality audits. In our Committee's recent comment letters, as well as this one, we continue to be concerned about the ongoing pipeline crisis of fewer new accountants entering the workforce and how the profession can keep talented auditors from leaving.

Finally, ensuring that the metrics are comparable for larger versus smaller firms is important so that investors and audit committees can interpret them appropriately. For example, we commend the PCAOB for discussing the differences between larger and smaller firms

regarding the use of specialists. Boritz, Kochetova-Kozloski, and Robinson (2015) find that auditors feel regulatory pressure to use fraud specialists already; however, the use of specialists introduces budgetary pressures due to their high costs (Hux 2017; Zimmerman, Barr-Pulliam, Lee and M. Minutti-Meza 2023). With smaller firms more likely to engage outside specialists compared to larger firms with in-house specialists, costs and usage rates for specialists can quickly become an "apples and oranges" comparison without context (Barr-Pulliam, Mason, and Sanderson 2023). Therefore, we again encourage the PCAOB to continue to ensure that metrics can be interpreted consistently, regardless of firm size, when there are fundamental practice differences based on firm size (e.g., in-house versus engaged specialists).

IV. PERSPECTIVES ON THE ECONOMIC ANALYSIS

We appreciate the Board's effort to comply with its economic analysis framework, which includes: "(1) the need for the rule, (2) the baseline for measuring the rule impacts, (3) the alternatives considered, and (4) the economic impacts of the rule (and alternatives), including the benefits and costs" (PCAOB 2024d). We are concerned that the analysis is inconsistent, imprecise, and incomplete. While proposals that consider new novel measures can be challenging to consider quantitatively, much of the current proposal is not novel. In addition, a more complete discussion of the alternatives would be helpful.

Need for the Rule

The proposal delineates two central issues: (1) "Allocative Inefficiency in the Market for Audit Services," and (2) "The Market for Information Related to Auditors and their Engagements is Inefficient."

Allocative Inefficiency in the Audit Services Market

The phenomenon of allocative inefficiency within the audit services market is explicated in the proposed rule, correlating the lack of visibility into audit services for investors and audit committees with consequential limitations on their capacity to monitor and select auditors effectively. Moreover, the proposal posits that this opacity obstructs investors' ability to ratify auditor appointments and efficiently allocate capital. This inadequacy is attributed to the risk that auditors may fail to deliver an optimal level of assurance to the market due to a deficient incentive structure, thereby impeding the dissemination of accurate, standardized, and decision-relevant information "as *sought* by the market" (p. 127, emphasis added).

However, the proposed rule goes beyond expressing concern of a "risk" of information inefficiency by affirmatively stating that "auditors are *not* supplying the market with an efficient level of information" (over- or under-auditing) because "*there is a lack of incentive* for firms" to do so (p. 127, emphasis added). Notably, the proposed rule cites no studies that support the notion that auditors are failing to supply an efficient level of information. Furthermore, the proposed rule provides no evidence that the market is seeking additional personnel, administrative, and operational information required by the proposed rule. In contrast, the PCAOB appears to acknowledge the lack of concrete market demand for this information:

> …it *appears* reasonable to *assume* that this lack of incentive for firms to provide such information is *likely* to cause the *apparent* undersupply of information, rather than the cost of providing the information being greater than the social benefit. (PCAOB 2024a, footnote 212, emphasis added.)

Assuming firms lack incentive to provide appropriate information in the absence of more efficient and effective monitoring by investors and audit committees ignores incentives such as the threat of legal liability, the damage to the firm's professional reputation if financial statements must be restated or deficiencies are found in PCAOB inspections, and PCAOB sanctions. The

frequent use of words like "appears," "assume," "likely," and "apparent" reveals the tenuous nature of the proposal's assertions.

Inefficiencies in Information Related to Auditors and Engagements

The second problem discussed in the proposal relates to the market's inefficiency in processing information pertaining to auditors and their engagements. As we previously discussed in Sections III and IV, the proposed rule delineates two categories of impediments to obtaining additional information about auditors and audit engagements: supply and demand. Supply-side constraints encompass factors such as a prevailing status-quo bias, proprietary disclosure costs, and the absence of mechanisms to disclose intricate, difficult-to-verify information reliably. Collectively, these constraints restrict the voluntary provision of information by audit firms. Conversely, demand-side challenges involve a free-rider dilemma, wherein investors bearing the costs of acquiring exclusive information are disincentivized due to the likelihood of involuntary disclosure to non-contributing parties. The free-rider problem serves as a disincentive for investors to seek nonpublic information.

The proposal argues that the proposed disclosures are justified in part by demand- and supply-side problems with limited information available to investors. The proposal discusses web usage statistics such as page views and searches as evidence of demand for information currently provided (p. 123). However, the proposal neglects to provide evidence demonstrating the inadequacy of available data or the appetite for these additional disclosures. The proposal might consider items like attendance at annual meetings, votes on auditor ratification, or passive versus active investors to quantify demand (see discussion in Section III on investor use of disclosures).

The proposal concedes that audit committees possess the authority to request requisite information from audit firms, suggesting that "investors know the least about the audit

engagement, as they are less involved in the issuer's operations compared to management, the board of directors, and the audit committee—and are even further removed from the audit process" (p. 132). However, the proposal fails to demonstrate investors' (or audit committees') demand for such information or establish the imperative for the mandated metrics.

The proposal asserts that most of the data are currently available to the PCAOB and audit committees. Thus, this economic analysis could describe what data is currently requested from audit firms, the variation observed in the provision of information, whether the PCAOB requires the mandated metrics, how the PCAOB uses this information, and how the PCAOB believes investors will use the information. In other words, what decisions will investors make that they are not currently able to make?

Consequently, the proposal's efficacy in addressing the purported deficiencies remains uncertain, particularly given the substantial information already accessible to audit committees and investors through existing channels and how distant retail investors are from the audit process. The question remains regarding the need for the proposal and whether benefits derived from investor use of the information exceed the cost of supplying it.

Baseline for Measuring the Rule Impacts

PCAOB policy requires that a baseline to measure a proposed rule be established. As investors ultimately pay the costs incurred in implementing and maintaining regulatory oversight (Kenan Institute of Private Enterprise 2024), this requirement allows the Board and the SEC to evaluate the net benefit to investors. Further, establishing an ex-ante baseline allows for an ex-post evaluation of the rule's efficacy.

The current proposal relies on measures of access to currently available data (e.g., number of webpage views or form downloads). While the data are interesting, no information is provided

suggesting who is accessing it or why they are doing so. Is it retail investors? Analysts? Academics? Would an increase in the number of views or downloads be a measure of success? As the PCAOB has committed to rigorous post-implementation reviews (PIR) of its standard-setting activities (PCAOB 2024e), we would have expected the criteria used in the PIR exercise to be explicated in the proposal.

Alternatives Considered

The proposal identifies two alternatives to the proposed rule. The first would alter the source of the information, with the PCAOB publishing the metrics rather than the firm. The second would require additional communication with the audit committee. Unfortunately, neither alternative addresses who is to communicate to whom nor the metrics to be disclosed.

Since the PCAOB first proposed disclosure of firm and engagement metrics (formerly known as audit quality indicators – AQIs) in 2015 (PCAOB 2015), large audit firms have disclosed information consistent with the proposed metrics in their "transparency reports" (e.g., Deloitte 2023; PwC 2023b). The proposal suggests that "only a small number of firms report firm-level metrics and these firms rarely report engagement-level metrics" (PCAOB 2024a, 19). However, the largest firms audit most of the public companies (Ryan 2022). Such coverage would likely inform most investors, particularly retail investors. Further, it supports the idea that *no* standard setting (i.e., not requiring any additional disclosures) should be considered a viable alternative.

Economic Impacts

Direct Benefits

Although the proposed metrics would not serve as direct measures of audit quality (p. 135), the proposed rule identifies the following direct benefits: (1) improved monitoring, (2) improved auditor selection, and (3) benefits to the PCAOB's inspection and enforcement programs and

scholarly audit research. Notably, these requirements are not identified when evaluating the need for the rule.

Starting with the direct benefit of enhanced audit performance through more effective investor and audit committee monitoring, the proposed rule cites academic research that found that smaller public companies perceive no deficiencies in the information provided by their audit firms (p. 140). Surprisingly, the proposal does not cite any academic literature suggesting a discernible information gap that could be rectified through the proposed metrics. Furthermore, the proposal attempts to establish a link between investors' utilization of the proposed metrics and their oversight of audit committee decisions, positing that investors could assess audit committee performance and raise potential concerns through dialogues with the board of directors or through the election of board and audit committee members (p. 141). However, the feasibility and prevalence of such direct engagement between investors and corporate boards remains questionable. In fact, such engagement between directors of large issuers and their investors is decreasing and often perfunctory (PwC 2023c), casting doubt on the likelihood of substantial interactions arising solely from the disclosure of additional metrics.

As articulated in the proposed rule and discussed in Section II of this letter, investors and audit committees could leverage the proposed metrics to gain insights into the conduct of their audit engagements and compare them with others. However, there exists a dearth of evidence delineating optimal benchmarks for these metrics. Does an increase in partner and manager engagement time or the assignment of more experienced audit staff necessarily improve audit outcomes? Increased partner and manager involvement may be indicative of underlying issues within the client's financial reporting system or the competence and integrity of client management. Moreover, the potential for firms to strategically overstaff with senior personnel to

enhance metric performance, thereby inflating audit costs, underscores the complexity of evaluating metrics in isolation. The PCAOB should have access to hundreds of inspections that could be mined to better understand such relationships.

Disclosure of additional metrics would conceivably benefit the PCAOB in its oversight capacity and provide years of fodder for academic research. However, like audit committees, the PCAOB can request any additional information it needs to fulfill its oversight responsibilities. It appears that the PCAOB likely has enough information from more than 20 years of inspections to articulate, either as part of the need for the rule or establishing a benchmark analysis, which metrics provide the critical insights for effective monitoring by inspection teams (and by extension, investors). What is unclear is how the *disclosure* of such metrics would change how the PCAOB performs its oversight role. What is clear is that the disclosure of additional metrics could furnish ample material for scholarly inquiry. Consequently, the potential benefits accruing to the PCAOB and academic research may not independently justify the prospective costs to firms associated with disclosing these additional metrics.

Indirect Benefits Linked to Competition

The proposed rule discusses several indirect benefits of the increased disclosures starting with the premise that if investors assess audit performance by certain firms as higher (as determined from the new metrics), they may infer higher quality financial reporting by issuers that are audited by those firms. Additionally, the proposed metrics could facilitate investors in gauging financial reporting risks independent of audit quality by identifying anomalies such as disproportionate allocation of audit resources to high-risk areas compared to similar issuers or prior year audits. As discussed in Section III, this benefit may not accrue to all investors proportionally, if at all.

The proposal also counts increased competition among audit firms as an indirect benefit resulting in *metrics management*. For example, consistent with our discussion earlier in this letter, the proposal acknowledges that (p. 145) "auditors may seek to manage their proposed metrics by redeploying staff resources, increasing focus on critical issues, or compensating staff based on quality performance ratings." While these measures may improve the firm's metrics, the impact of the changes on audit quality is unclear. Finally, the proposed rule discusses the indirect benefits of improved financial reporting quality, such as improved capital allocation decisions, an increase in the supply of capital because of less perceived capital market risk, and reduced cost of capital to issuers. Given the vast literature on the cost of capital, it would be helpful to quantify the impact of metrics on cost of capital decisions.

Costs of the Proposal

The costs identified by the proposal include (p. 162): (1) direct costs of building the reporting infrastructure, (2) direct costs to produce the firm and engagement metrics, (3) indirect cost of understanding and integrating the new metrics into decision-making frameworks, (4) indirect cost of revising audit approaches, and (5) indirect costs of switching auditors (as applicable). Quantitative assessments are provided solely for the direct costs of infrastructure development and metric production. The estimated cost range for building or retrofitting IT systems to generate the new metrics is between $363 and $506 million across all affected firms, while total direct costs for metric production are approximately $68 million. All other cost considerations are discussed qualitatively. Further, there is no matching of these costs with the benefits.

The proposal acknowledges the following potential unintended consequences, some of which we discuss in other sections of this letter (pp. 171-174): (1) auditors may exit the market for

accelerated filers and large accelerated filers due to increased competition and costs, (2) some auditors may strategically manage their issuer portfolios (by divesting themselves of any clients that would trigger the need for producing the new metrics), (3) investors, audit committees, and auditors may misinterpret or misuse the proposed metrics, (4) auditors may attempt to manipulate the proposed metrics, and (5) there may be impacts on the audit labor market.

The unintended consequences outlined in (1) and (2) above possess the potential to exacerbate market concentration in the audit services market, as we discussed earlier in Section III. With each new regulation of audits and auditors, firms perceiving inadequate compensation for compliance may opt to exit the market, reducing the pool of audit firms. The reduction in the pool of qualified audit firms diminishes potential benefits derived from the use of the metrics to differentiate between firms.

Contradicting previous assertions within the proposal, the proposal argues that users may misinterpret or over-rely on the proposed metrics as measures of audit quality, potentially leading to erroneous decisions. This potential for negative outcomes is compounded by metrics management, as discussed above, as well as the ambiguity of some of the proposed metrics in terms of their relationship to audit quality. Despite existing mechanisms such as firms' quality control systems and PCAOB oversight, metrics management by audit firms may significantly undermine the perceived benefits of the metrics.

The discussion on costs concludes with a brief acknowledgment of potential impacts on the audit labor market. The proposal suggests that the audit labor market could be negatively impacted "if individual auditors believe increased public scrutiny negatively impacts their personal reputations or increases their work pressures" (p. 174). Thus, it is likely that firms striving to enhance their metrics will compete for a diminishing pool of qualified candidates, potentially

driving up personnel costs. Moreover, increased competition for qualified candidates may incentivize audit firms to hire client personnel with industry experience, further escalating personnel expenses for both hiring firms and issuers and also potentially introducing independence concerns (Hurley, Mayhew, Obermire and Tegeler 2021) for a discussion on dysfunctional manager and investor behavior in response to differential audit quality).

Finally, as the PCAOB has conducted its analysis, it would be helpful for the proposal to spell out which costs would generate which benefits.

V. CONCLUSION

We appreciate this opportunity to comment on the PCAOB (2024a) proposal, and we commend the PCAOB for its continuing efforts to promote audit quality by emphasizing firm and engagement metrics. Our comment letter has provided overall observations on the proposal, key takeaways from research, and our assessment of the PCAOB's economic analysis.

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