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Office of the Secretary
Public Company Accounting Oversight Board
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Concept Release on Possible Rulemaking Approaches to Complement Application of Section 105(c)(6) of the Sarbanes-Oxley Act of 2002, PCAOB Rulemaking Docket Matter No. 031

Dear Office of the Secretary:

Ernst & Young LLP (Ernst & Young) is pleased to submit comments on the Public Company Accounting Oversight Board's (PCAOB or the Board) request for comment on its Concept Release relating to Section 105(c)(6) of the Sarbanes-Oxley Act of 2002 ("the Act"), which authorizes the Board to impose sanctions on registered public accounting firms and their supervisory personnel for failing reasonably to supervise an associated person who has violated certain laws, rules, or standards.

Ernst & Young supports the Board's goal that registered public accounting firms have appropriate supervisory structures in place. Adequate supervision is an essential element of a firm's system of quality control.

The Concept Release requests comment on whether it is appropriate to pursue, through rulemaking, the Board's stated objectives of "increasing clarity about who within the firm is accountable for various responsibilities that bear on the quality of the firm's audits," or whether there are reasons to pursue those objectives through other means. Although we support the Board's objective of increasing clarity within accounting firms regarding supervisory responsibilities, we do not believe it is necessary for the Board to adopt separate rules under Section 105(c)(6); rather we believe the Board should clarify responsibilities for quality control functions within the existing audit quality control standards. While we believe the quality control standards can provide an appropriate framework for achieving the Board's objectives, if the Board ultimately determines it necessary to adopt separate supervision rules, we would encourage the Board to pursue an approach to rulemaking that, in the Board's words, "only in general terms requires assignment of responsibility and documentation of that assignment."

We have reached these conclusions after carefully considering the existing professional standards relating to supervision. There are precise standards with respect to the engagement team itself. These requirements were most recently set forth in Auditing Standard No. 10, *Supervision of the Engagement Team* (AS 10), which is awaiting SEC approval[1].

Supervisory requirements also currently exist in the Board's quality control standards[2]. For example, QC 20.03 states that "[a] firm has a responsibility to ensure that its personnel comply with the professional standards applicable to its accounting and auditing practice." Further, QC 20.22 states, "[r]esponsibility for the *design* and *maintenance* of the various quality control policies and procedures should be assigned to an appropriate individual or individuals in the firm."

The Board might well consider expanding the quality control standards to clarify certain supervisory obligations. We note in this regard that the Board's *Current Standard-Setting Agenda*[3] includes a project to seek comment on a concept release on its quality control standards in the second quarter of 2011[4] and to issue a proposed standard in the first quarter of 2012. Among other things, consideration might be given to making clearer the fact that an engagement team member may appropriately rely on the firm's system of quality control in fulfilling certain of his or her professional obligations. For example, an engagement team member should be able to rely on a firm's independence systems to have adequately monitored audit client business relationships and other matters that may bear on the firm's independence.

The Board's Release, however, seems to contemplate a rule under which responsibility for audit failures could be readily assigned to persons outside of the audit engagement team based on a breach of supervision obligations. The Release states that, "…if a firm complied with the rule, it would be possible to identify, with respect to a particular violation in an audit, any individuals who had responsibility for any aspects of the QC system that failed, and to identify other individuals with supervisory responsibility for those individuals' performance relating to the QC system."

We do not believe that such a clear correlation exists in the auditing profession, due to both the nature of the activities in an audit and the variety of firm structures that might exist to provide controls over audit quality. Most of the work with respect to an audit is done by the audit engagement team itself, without direct involvement of supervisory personnel (such as an office managing partner, or an area director, or a training supervisor, or a person responsible for developing audit guidance). Of course, an audit team may reach out for assistance from others in the firm on specific issues. For example, a firm's actuaries may assist the team on actuarial issues that arise in the audit. Also, our firm has traditionally

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1 Supervisory responsibilities are also set forth in other provisions of the Board's auditing literature, including Auditing Standard No. 13, *The Auditor's Responses to Risks of Material Misstatement* (AS 13), and AU Section 230, *Due Professional Care in the Performance of Work* (AU 230).

2 Interim Quality Control Standard 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (QC 20), Interim Quality Control Standard 30, *Monitoring a CPA Firm's Accounting and Auditing Practice* (QC 30), and Interim Quality Control Standard 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement* (QC 40).

3 http://pcaobus.org/News/Events/Documents/10132010_SAGMeeting/OCA_standards-setting_agenda.pdf

4 We also note the issuance of the PCAOB's recent briefing paper, *Designing and Implementing A System Of Quality Control,* that was discussed at the October 13-14 Standing Advisory Group meeting.

promoted a culture of consultation within the firm, and we have a group of partners in our professional practice department whose chief responsibility is to provide assistance on difficult accounting or auditing matters. But we would not consider such persons to be "supervisors" of the audit, nor would their activities fit within a general understanding of the word "supervisor." Moreover, we think that characterizing them as such, and making them more broadly liable in the event of an audit failure, would not lead to higher quality audits, and in fact might undermine our consultative culture.

Of course, there may be instances of egregious failures in quality controls, and the Board might properly use its existing enforcement powers to address such instances. But we think this would be an unusual event. We think the existing quality control standards state this accurately: footnote 5 in QC 20 states that, "…deficiencies in individual…engagements do not, in and of themselves, indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards." This is because persons responsible for various elements of the system of quality control do not have day-to-day oversight and are not in a position to, nor are they intended to, oversee the work performed by an audit engagement team on a specific engagement.

In this regard, it is useful to contrast the structure of an accounting firm with the organization of a broker-dealer firm. Section 105(c)(6)(B) tracks the duty to supervise language of Section 15(b)(4)(E) of the Securities Exchange Act, which applies to broker-dealers. As we understand the regulatory environment for broker-dealers, enforcement cases are routinely brought against supervisory personnel for violation of their duty to supervise obligations in instances of violations of professional standards by lower-level personnel such as securities salespersons.

The day-to-day activities of audit personnel have very little in common with the activities of broker-dealer registered representatives. The activities of audit engagement teams involve the extensive exercise of professional judgment, which is unlike the typical role of a broker-dealer salesperson. The monetary incentives, the organizational structure, the culture of consultation, and other aspects of accounting firms would make it inappropriate in our view to look to Section 15(b)(4)(E) of the Exchange Act, and enforcement activities thereunder, as a model for the PCAOB's approach to this issue.

We note that if the PCAOB does decide to move forward with rulemaking in this area, the PCAOB should pursue a rule that would give firms flexibility in the assignment of responsibilities and documentation of those assignments. Given the diversity of the firms and differences in operating policies and procedures, the Board's proposed requirements should be sufficiently flexible to allow appropriate and practical implementation by firms of all sizes, structures and complexity.

For example, public company audit firms range in size (e.g., from firms that are members of global organizations to domestic single-office firms), structure (e.g., focus on industry, service line, geography), and general complexity of audit engagement portfolio. As a result, firms have established quality control and operational structures specific to their needs, and implemented tailored policies and procedures to facilitate compliance with the PCAOB's quality control standards. These structures address responsibilities for the design and maintenance of the various quality control policies and procedures that are required to be assigned to appropriate individuals in the firm, based on consideration of the proficiency of the individuals, the authority to be delegated to them and the extent of supervision to be provided.

We believe the approach articulated by the Board in Part II of the Release, that would formulate requirements that "only in general terms requires assignment of responsibility and documentation of that assignment," would be the most appropriate approach to any rulemaking. As proposed by the Release, such a rule would build on the existing requirement that responsibility for the design and maintenance of quality control policies and procedures be assigned to appropriate individuals and would require firms to document specific assignments, in a manner consistent with a firm's current obligations under the Board's quality control standards.

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We would be pleased to discuss our comments with members of The Public Company Accounting Oversight Board or its staff.

Sincerely,

Ernst & Young LLP