

May 11, 2020

Office of Secretary  
PCAOB  
1616 K Street, NW  
Washington, DC 20006-2803

Dear Office of the Secretary:

***Re: PCAOB Rulemaking Docket No. 046:  
Concept Release, Potential Approach to Revisions to PCAOB Quality Control Standards***

CFA Institute<sup>1</sup> appreciates the opportunity to share our views and provide input on the Public Company Accounting Oversight Board's (PCAOB's or Board's) [Concept Release, Potential Approach to Revisions to PCAOB Quality Control Standards](#) (the Concept Release).

CFA Institute is providing comments consistent with our objective of promoting fair and transparent global capital markets and advocating for investor protections. An integral part of our efforts toward meeting those goals is ensuring that corporate financial reporting and disclosures – and the related audits – provided to investors and other end users are of high quality. Our advocacy position is informed by our global membership who invest both locally and globally and in consultation with Corporate Disclosure Policy Council (“CDPC”).<sup>2</sup>

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<sup>1</sup> CFA Institute is a global, not-for-profit professional association of nearly 171,400 investment analysts, advisers, portfolio managers, and other investment professionals in 165 countries, of whom more than 164,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 154-member societies in 77 countries and territories.

<sup>2</sup> The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

## Audit Quality: Investors Primary Objective

### Increased Transparency to Investors: Essential to Improve Audit Quality

We believe audit quality is the single most important area that needs significant improvements both relating to the audit process and product and the related regulation. In our [comment letter](#) responding to the [UK Independent Review into the Quality and Effectiveness of Audit Call for Views \(Brydon Review\)](#), CFA Institute wrote extensively about our views on audit quality. In our Brydon Review comment letter we cite our [comment letter](#) to the [UK Competition & Markets Authority \(CMA\) Statutory Audit Service Market Study](#). Below is an excerpt from those letters that highlights both the importance of audit quality and the need for increase transparency. Presently investors have little information upon which to judge audit quality. ***We do not find audit quality to be an elusive concept, simply one lacking in sufficient transparency for market participants to make informed judgements on how to move forward.***

*As an investor organization, we strongly support the efficient functioning of markets. Markets generally benefit from broad competition. Such competition should lead to value for money and increased quality. The Big 4 (PwC, EY, Deloitte and KPMG) represent a formidable oligopoly. **However, for a market to be perfectly competitive not only does an efficient market need numerous buyers and sellers but they also need them to be well informed. In the current audit market, buyers of audit services – ultimately investors – do not have the information necessary to judge audit quality. The inability to observe audit quality is rightly mentioned within the Audit Market Study (e.g. Paragraph 2.4)***

***Investors' rely on agents or intermediaries (the audit committee) and the seller (the accounting firm) to protect their interests and ensure the performance of high quality audits. These intermediaries, however, have incentives that may run counter to the objective of protecting investors' interests. Audit committees may pressure auditors to lower price to engender themselves to company management and auditors may seek to ingratiate themselves with management by exercising less professional skepticism – or being less challenging of management's decisions – as well as reducing audit procedures and quality to retain audit engagements and enhance their profits. The simple reference to companies under audit by auditors as the "client" has the effect of connoting a dependent rather than independent relationship and confusing the fact that the ultimate client, or the buyer, is the investor. These incentives, combined with limited information and transparency regarding the audit from both audit committees and auditors, makes it even more challenging for investors (buyers) to judge quality. Further complicating the ability to judge audit quality, is that audit regulators also provide little detail when communicating to investors and the public more broadly about audit quality. As we note above, the intense media reaction can distort the narrative on audit quality. Investors and other stakeholders want to, and should, rely on communications from three principal sources for gaining an understanding of the quality of the audit. These are: 1) the audit committee, 2) the auditor's, and 3) the regulator. An efficient market requires more than simply a plentiful number of buyers and sellers, but for them to be well informed by those charged with protecting their interests. This is not the case in the audit market.***

*Official bodies engaged in audit standard-setting and enforcement (e.g., FRC, IAASB, PCAOB, etc.) have worked to adopt improvements – including those we have advocated for – in standard-setting over the last two decades. They have also worked to draw greater attention to the importance of audit quality by increasing the ability of auditors to pushback on "challenging clients." While these improvements are welcomed, regulatory inspection results over the last several years show that improvements – particularly in the communication from audit committees and auditors as well as from regulators are still needed. As we noted in our recent letter to the Public Company Accounting Oversight Board (PCAOB's) in relation to its Strategic Plan (2018-2022), **investors have little transparency into the activities and findings of those charged with protecting their interests and that improvements continue to need to be made. Only recently have audit reports improved – recognizing that the UK market has lead the way in advancing some of these reforms. That said, as we recently advised the PCAOB, we have little insight into the severity of the regulators findings and how to gauge the quality of the auditors work and the regulators findings. As we***



*note in our letter to the PCAOB we need more analysis, synthesis and contextualization of the regulators findings – not just in the US, but globally – to be able to gauge audit quality.*

*Presently, there is little to no competition on audit quality not only because it is challenging for everyone to judge, but because managements generally don't influence the audit committee to select the toughest or highest quality auditor. Further, **many audit committees and investors select the Big 4 firms, because they have limited ability to ascertain audit quality and they use brand identity (e.g. Big 4) and herding behavior as a basis for their decision-making.***

*While the Audit Market Study more fully considers the importance of audit quality (Pages 31-40), the remedies – in our view – suggest the CMA is perhaps still too narrowly focused on increasing the number of market participants (i.e. sellers) without precise articulation regarding how increasing the number of sellers will result in improvements in the quality or price of audits. **Our view is that the CMA's attention needs to be on how to improve quality and communication (transparency) to investors.** We believe the CMA research has the potential to contribute toward this end goal by enhancing the information exchange between market participants. **With more information, investors will be able to better judge the quality of the audit; the price paid for the audit; the effectiveness of the audit committee in overseeing the auditors from selection, risk assessment, performance of audit procedures and reporting of results; and the effectiveness of regulators.** We, therefore, want to emphasize that more choice in the market that leads to more competition does not necessarily deliver better quality audits. We are concerned that more participants might actually create more competition based upon price rather than quality. Audit quality – not increasing the number of market participants – is top of mind for investors.*

*As investors – who strongly support efficient markets – **the audit market cannot operate efficiently when there is a lack of transparency on audit quality.** We believe a capital markets solution with regulatory oversight of quality and disincentives is the solution. We also believe improvements in regulatory oversight by an audit regulator are an integral part of the equation in improving audit quality. We do not believe the remedies proposed here should be implemented without a clear linkage of the actions to the responsibilities of audit regulators. Our response to the remedies that follow are guided by whether they will enhance this information exchange, increase audit quality and are regulations which balance a free, but fair, market.*

## Audit Quality Indicators: An Integral Part of Transparency

Per the Concept Release:

*We anticipate that a future PCAOB QC standard would include requirements that expressly address required communications by the firm or engagement teams to audit committees, the SEC, the PCAOB, or otherwise as required by law, regulation, and PCAOB standards and rules (for example, communications under Section 10A of the Exchange Act, AS 1301, Form AP, or Form 2, or in conjunction with company listing requirements).*

This is insufficient. The details of the quality control system of each audit firm should be fully communicated to the users of financial statements including investors – as the standard being proposed is meant to accommodate public company audits, companies that are public because of their listing, in the United States. Firms should be required to provide disclosures of audit quality and quality control, including audit quality indicators (AQIs) and how the firm responds to identified deficiencies. We believe the [PCAOB should complete its project on audit quality indicators](#).

We [agree with the CII](#) that firms should be required to establish quantifiable performance measures for the achievement of quality objectives. As noted above, audit quality is not an elusive concept. Quality metrics are part of every manufacturing process. Audit is not so subjective that it cannot include metrics to judge quality. Indeed, audit quality is measurable through AQIs and transmission of such information to investors (buyers).

CII states, and we agree, that a portfolio of properly chosen AQI's of engagement-level and firm-level data would be useful to investors. As indicated in the Concept Release, "investors are the primary beneficiaries of the financial reporting process and the group at which audit quality is ultimately aimed," yet investors have limited data available to them regarding audit quality. As we note above, attention needs to be paid on how to improve quality and communication (transparency) to investors. With more information, investors will be able to better judge the quality of the audit; the price paid for the audit; the effectiveness of the audit committee in overseeing the auditors from selection, risk assessment, performance of audit procedures and reporting of results; and the effectiveness of regulators. Only with increased transparency can buyers of audit services (i.e. investors) and sellers of audit service (i.e. auditors) communicate and reduce the agency issues associated with the audit selection process.

The [CII letter](#) outlines that an audit quality report of a larger audit firm should include, at a minimum, a qualitative discussion of:

- *How they define the U.S. firm and its relationship with foreign affiliates*
- *How the firm performs individual audits*
- *How they run the business*
- *How they think about the role and relevance of the auditing profession*
- *How they train audit personnel*
- *How they compensate and incentivize audit professionals*
- *How they invest in new and enhanced audit technologies*
- *How they have designed the firm's governance and structure*
- *Information that would inform an audit committee's or investor's consideration of the audit firm's commitment to factors that impact audit quality.*

It would also be helpful if audit committees were required to provide an independent certification to shareholders that they are satisfied with the report that they have received about audit quality measures put in place by their audit team. It would provide an additional and perhaps significant push to ensure that audit quality is front and center in terms of partner incentives. It would also mean that audit committees have significant incentives to focus on quality above price. To further support transparency, we believe there is also a need for the PCAOB to be more transparent and timely with its inspection reports.

### **Overall Support for Concept Release on Audit Quality**

CFA Institute welcomes the proposals in the Concept Release. An audit firm's system of quality control (QC) is foundational to audit quality. We agree it is appropriate to revise existing PCAOB QC standards, which were originally developed and issued by the American Institute of Certified Public Accountants and adopted as interim standards in 2003.

As the Concept Release notes related to the need for a revision:

*Our current QC standards were originally developed and issued by the American Institute of Certified Public Accountants (AICPA) before the PCAOB was established. **The auditing environment has changed significantly since that time, including evolving and greater use of technology by firms in performing engagements and in relation to QC activities.** Some firms have also significantly increased their focus on governance and leadership, incentive systems and accountability, and monitoring and remediation. Current PCAOB QC standards do not reflect these developments.*

Furthermore, the revision is essential given the PCAOB's own inspection findings:

*Some firms have also augmented their monitoring and remediation processes, including through implementing or enhancing ongoing monitoring activities and internal inspection processes, establishing processes for considering PCAOB inspection findings, performing root cause analysis, and increasing remediation efforts. Observations from our oversight activities have shown that improvements in quality controls can enhance the quality of audits. **Not all firms, however, have made such improvements to their QC systems or have done so to the same degree.***

Indeed, the PCAOB's December 2018 Staff Inspection Brief<sup>3</sup> states, with respect to the concept of **auditor independence**, the following:

*These recurring deficiencies suggest that **some firms and their personnel either do not sufficiently understand applicable independence requirements or do not have appropriate controls in place to prevent violations.***

The PCAOB's 2016 Staff Inspection Brief 2016<sup>4</sup> also note issues with respect to **professional skepticism** as follows:

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<sup>3</sup> <https://pcaobus.org/Inspections/Documents/Inspections-Outlook-for-2019.pdf>

<sup>4</sup> <https://pcaobus.org/Inspections/Documents/Inspection-Brief-2016-3-Issuers.pdf>

*....continue to raise concerns about **whether some auditors appropriately apply professional skepticism in the course of their audits, particularly** in those areas that involve significant management judgments or transactions outside the normal course of business, as well as the auditor's consideration of fraud.*

Given the changing environment and the fact that inspection staff continue to identify audit deficiencies related to matters critical to audit quality, we support the PCAOB's proposal to amend current QC standards. As we noted above, it needs to include AQIs and improved transparency.

### **Support High-Quality Global Standards**

Many firms are subject to not only the PCAOB's QC standards but also those of the International Auditing and Assurance Standards Board (IAASB), or national standards that use the IAASB's standards as a base. We agree with the PCAOB when it notes the need to converge or utilize a comment framework as noted in the Concept Release as follows:

*Due to the foundational nature of QC systems, we believe that it would not be practical to require firms to comply with fundamentally different QC standards. Unnecessary differences in QC standards could even detract from audit quality by diverting firms' efforts from focusing on matters of fundamental importance to effective QC systems.*

Accordingly, we support the Board using proposed [International Standard on Quality Management 1](#) (ISQM 1) as a starting point for a future PCAOB QC standard. ***CFA Institute has always supported high-quality global standards. Uniform global standards of high-quality are particularly useful for investors given that they invest globally. That said, just as when we supported converge to IFRS, we believe standards must be test and of high-quality. We caution the PCAOB. They are leaning on the IAASB's framework that is yet to be tested. We urge the IAASB and the PCAOB to test the framework together. We believe standards of high-quality to be more important than global, uniform standards.***

We also urge the Board to continue monitoring the developments of the IAASB as well as standard setters in other jurisdictions who are contemplating updates to their quality control standards. We believe it is important to promote consistency of the framework of quality control standards and minimize unnecessary differences and incremental effort that do not benefit audit quality.

There may be reasons for differences between proposed ISQM 1 and a future PCAOB QC standard, based on the legal and regulatory framework in which the US operates. However, we encourage the Board to minimize the differences and maintain an appropriate integrated, principle and risk-based approach.



## **Governance and Leadership: Essential for Accountability to Quality**

Adding the proposed ISQM 1 component of governance and leadership is a significant enhancement to existing PCAOB QC standards. The Concept Release notes:

*The firm's governance and leadership component establishes the environment in which the QC system operates. This component addresses the firm's culture, decision-making process, actions, organizational structure, and leadership. A firm's culture and tone set by leadership can promote the importance of quality and support the exercise of professional skepticism. The PCAOB has long considered firm governance and leadership to be a crucial aspect of firms' QC systems.*

We believe, however, that this goal is most likely to be achieved if firm leaders are held accountable for results achieved. And this in turn can only be achieved through independent oversight of the quality control system and where there is transparency of the details of the quality control system of each audit firm (see Communication section below).

We agree with the [comment letter](#) from the Council of Institutional Investors (CII) and concur that a future PCAOB QC standard should incorporate the recommendation of the U.S. Department of Treasury Advisory Committee on the Auditing Profession (ACAP)<sup>5</sup> that audit firms' boards have: *independent members with full voting power . . . and/or advisory boards with meaningful governance responsibilities*. Given the importance of independent oversight to audit quality, we believe audit firms should be required to have independent oversight of their systems of governance and quality control and consequently that all of the largest audit firms should be required to have independent directors on their boards.

## **Support the Risk Assessment Approach**

We support the proposal to enhance quality control and are in favor of the risk assessment approach to drive quality. The Concept Release states:

- A risk-based approach to a firm's QC system such as that proposed by the IAASB could:*
- *Prompt a more proactive and tailored approach to anticipating and responding to quality risks;*
  - *Provide a feedback loop from monitoring activities back to the risk assessment process to support continual improvement in QC systems.*

The risk-based approach tailors the risk assessment process to an individual firm's circumstances and the nature of its engagements enabling the firm to focus on the right issues and design their systems to address those risks. It also enables the firm to assess on a regular basis the effectiveness of the steps they have taken. AQIs are an integral part of this risk assessment approach.

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<sup>5</sup> <https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>

### **Support for the Monitoring and Remediation Process**

We agree with the statements in the Concept Release related to remediation and monitoring as follows:

*The firm's monitoring and remediation process involves activities to (1) evaluate the design, implementation, and operation of the components of the QC system to determine whether the quality objectives have been achieved, and (2) address identified deficiencies in the QC system and engagements. Monitoring and remediation is a crucial part of an effective QC system because it creates a feedback loop to inform the firm's risk assessment process to drive continual improvement.*

*We are aware that some firms, particularly US global network firms, have made significant efforts to enhance their systems for monitoring and remediation. These efforts include increased attention to ongoing monitoring activities, internal inspections of both in-process and completed engagements, root cause analysis of both positive quality events and deficiencies, and remedial actions to address identified QC deficiencies. **Not all firms, however, have made meaningful improvements in these areas.***

Given that not all firms have made meaningful improvements the new QC standard should have a clear mandate for monitoring and remediation with clear requirements to conduct root cause analysis of identified deficiencies and implement remedial actions.

### **Scalability Issues: Investors Need Uniform Quality Regardless of Audit Firm Size**

The Concept Release addresses the concept of scalability of quality control measures as follows:

*We believe that any revisions to the QC standards the PCAOB may adopt should be appropriately scalable, so a firm can tailor its QC system appropriately based on the firm's size and complexity and the nature of the engagements performed, commensurate with applicable quality risks.*

We agree. However, we would like to emphasize that the users of financial statements, especially in the case of audits of listed companies, place great importance on maintaining the same level and consistency of audit quality regardless of the size of the audit firm or audited company.

The Concept Release goes on to indicate:

*To be scalable, such requirements would need to provide for less formal engagement monitoring activities by smaller, less complex firms, but would also mandate more robust and formal activities for larger, more complex firms.*

It should not be automatically assumed that the activities of smaller firms should be less robust than those of larger more complex firms but rather that the risks associated with these smaller firms (for example, staff with lack of relevant expertise) are accounted for in the QC standards.



**Mapping Exercise Needed**

While the Concept Release identifies what the new PCAOB QC standard would include in addition to ISQM 1, we suggest that when the new QC standard is developed that the PCAOB conduct a mapping exercise to identify and illustrate the linkage and key differences between the PCAOB's current and new QC standards. We note that the Concept Release focuses on the differences between ISQM1 and the proposed QC standards. However, our main concern is that, as a result of the tailored approach, it may not be entirely clear for many firms whether what they are doing now will fit within the new requirements, or what they might need to do to ensure that they do comply.

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Thank you again for the opportunity to provide our input on the Concept Release. If you or your staff have questions or seek further elaboration of our views, please contact Mohini Singh at +1.434.951.4882 or by email at [mohini.singh@cfainstitute.org](mailto:mohini.singh@cfainstitute.org) or me at +1.212.754.8350 or by email at [sandra.peters@cfainstitute.org](mailto:sandra.peters@cfainstitute.org).

Sincerely,

*/s/ Sandra J. Peters*

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Cc:  
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