



November 12, 2010

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Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, D.C. 20006-2803

**Re: Request for Public Comment: *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. 31**

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants (AICPA). The CAQ appreciates the opportunity to respond to the Public Company Accounting Oversight Board's (PCAOB or the Board) *Concept Release on Possible Rulemaking Approaches to Complement Application of Section 105(c)(6) of the Sarbanes-Oxley Act of 2002* (the Concept Release or Release). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual or CAQ Governing Board member.

The CAQ supports the Board's view that accounting firms should have supervisory structures in place that provide reasonable assurance relative to the performance of high quality audits. This is an essential element of a firm's system of quality control. And, of course, we recognize Congress included Section 105(c)(6) in the Sarbanes-Oxley Act and, accordingly, that it is incumbent on the Board to consider carefully whether rulemaking in this area is needed. The Board has taken steps to inform their consideration of rulemaking through discussion of this topic at Standing Advisory Group meetings<sup>1</sup> and now through the issuance of the Concept Release.

<sup>1</sup> Failure to Supervise was discussed by the PCAOB Standing Advisory Group (SAG) on October 14, 2010 and February 27, 2008. See SAG meeting archive at <http://pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>

The Concept Release requests comment on whether it is appropriate to pursue, through rulemaking, the Board's stated objectives of "clarity within firms about accountability for supervisory responsibilities and the creation of documentation identifying lines of accountability," 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 engage in an independent rulemaking process directed at making and assigning supervisory responsibilities; rather we believe the Board could address clarifying responsibilities for quality control functions within the audit quality control standards.

The provision of high-quality audits is an objective that is often embedded in multiple functions of an accounting firm, and the related quality control responsibilities are dispersed widely within the firm. As such, if the Board determines it is appropriate to establish requirements for firms to "make and document clear assignments of supervision responsibilities that are already an element of their audit practice," as more fully discussed in item 4 below, we urge the Board to build those requirements into the Board's existing quality control standards to preserve and enhance current audit quality control systems. Further, as described in the Concept Release, if the Board pursues new requirements, we would encourage the Board to pursue an approach to standard setting that "only in general terms requires assignment of responsibility and documentation of that assignment."

We further explain our views below.

1. An audit engagement team is responsible for the performance of the audit engagement while other persons in the accounting firm are responsible for the establishment and maintenance of an audit quality control system that provides reasonable assurance that the firm and its personnel comply with professional standards and the firm's standards of quality.

As for the audit engagement team itself, the Board's professional standards include requirements with respect to supervisory responsibilities. These requirements were most recently set forth in Auditing Standard No. 10, *Supervision of the Engagement Team* (AS 10), which is awaiting SEC approval<sup>2</sup>.

Outside of the engagement team, these supervisory responsibilities are best addressed by the Board's quality control standards<sup>3</sup>. 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" [emphasis in original].

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<sup>2</sup> 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).

<sup>3</sup> 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).

We note that the last sentence of the first paragraph on page 12 of 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 individual’s performance relating to the QC system.” We believe this incorrectly implies that deficiencies in individual audit engagements always are the result of, and can be directly linked to, failures in a system of audit quality control. Footnote 5 in QC 20 indicates 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.” As such, we believe that the last sentence of the first paragraph on page 12 of the Release does not accurately reflect the objective of a system of quality control.

We do, however, believe that there are opportunities to improve and clarify the Board’s quality control standards. We note in this regard that the Board’s *Current Standard-Setting Agenda*<sup>4</sup> includes a project to seek comment on a concept release on its quality control standards in the second quarter of 2011<sup>5</sup> and to issue a proposed standard in the first quarter of 2012. Although we are not providing specific suggestions for improvements to the Board’s quality control standards, the PCAOB should address whether supervisory responsibilities related to a firm’s audit practice could be made clearer as part of its planned quality control standards revision project. Among other things, consideration might be given to making clearer the fact that an engagement team 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, among other things, to have adequately monitored audit client business relationships and other matters that may bear on the firm’s independence.

2. We are concerned that the Release suggests a requirement that currently does not exist in the Board’s professional standards: assigning *specific* supervisory responsibilities to *specific* individuals within a firm. The Release states that the Board is considering whether rules requiring firms to make and document clear assignments of audit practice supervision responsibilities “...would serve to further the public interest and protect investors by increasing clarity about *who* within the firm is accountable for various responsibilities that bear on the quality of the firm’s audits.” [Emphasis added.] The Release further 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 understand the Board’s objective relative to possible rulemaking is to facilitate improved systems of audit quality control and to enhance audit quality broadly. We believe this can best be accomplished by providing clarification of responsibilities for implementing the quality control function within the quality control standards, as opposed to pursuing independent rulemaking to require assignment of specific supervisory responsibilities to specific individuals.

<sup>4</sup> [http://pcaobus.org/News/Events/Documents/10132010\\_SAGMeeting/OCA\\_standards-setting\\_agenda.pdf](http://pcaobus.org/News/Events/Documents/10132010_SAGMeeting/OCA_standards-setting_agenda.pdf)

<sup>5</sup> 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.

To illustrate our concern, it is important to recognize that most accounting firms have a wide range of professionals whose responsibilities affect the functioning of the system of audit quality control. By way of illustration, a firm may have individuals with the following responsibilities:

- A Chairman or CEO who is responsible for setting the “tone at the top”. Among other things, he or she typically communicates the importance of performing quality audits and helps set budgetary priorities with respect to audit quality and risk management objectives.
- A person in charge of the firm’s audit practice who shares overall responsibility for audit quality.
- A person with responsibility for the firm’s consultation and professional practice activities that have a direct bearing on audit quality.
- A person with responsibility for the firm’s independence activities.
- A person with responsibility for the firm’s development of audit methodology.
- A variety of persons – office managers, regional managers, national office personnel, etc. – who are responsible for the assignment of partners to particular engagements, evaluating budgetary issues, and approving acceptance of new audit clients.
- A person with responsibility for a firm’s internal quality control review processes - that is, processes whereby individuals independent of the audit engagement team review a sample of the work of the firm’s audit partners on a periodic basis.
- A person with responsibility for the firm’s training of audit practice personnel.

In each of these areas, there may be – particularly at the largest firms – scores of persons assigned to the particular departments or units, many of whom may in turn supervise other personnel. For example, the largest firms may have several dozen people working in the independence area, with a range of responsibilities assigned to each person.

This very brief summary of a firm’s structure that comprises a system of audit quality control illustrates an important point: quality control activities are embedded throughout an accounting firm and, in most instances, it would be inappropriate to designate a single “supervisory person” for each individual audit engagement partner responsible for executing an audit. Because of the nature of audit quality control systems, and the performance of audits in accordance with applicable professional standards, 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.

What many individuals within a firm *do* have are responsibilities with respect to audit quality control, and it is appropriate for the PCAOB to have the authority and power to bring enforcement proceedings against persons who fail to fulfill their quality control responsibilities. That said, we believe that the Board’s existing rules and standards provide that authority and power. As a general matter, an accounting firm professional must discharge his or her responsibilities with due professional care, as required by AU 230. Further, Rule 3400T of the Interim Quality Control Standards states:

A registered public accounting firm, *and its associated persons*, shall comply with quality control standards, as described in -

- (a) the AICPA's Auditing Standards Board's Statements on Quality Control Standards, as in existence on April 16, 2003 (AICPA Professional Standards, QC §§ 20-40 (AICPA 2002)), to the extent not superseded or amended by the Board; and
- (b) the AICPA SEC Practice Section's Requirements of Membership (d), (f)(first sentence), (l), (m), (n)(1) and (o), as in existence on April 16, 2003 (AICPA SEC Practice Section Manual § 1000.08(d), (f) <sup>6</sup>, (j), (m), (n)(1) and (o)), to the extent not superseded or amended by the Board. [Emphasis added.]

3. The Concept Release cites to the legislative history linking Section 105(c)(6)(B) to the liability of broker-dealers under federal law for failure to supervise. While the duty to supervise requirement in the Exchange Act has proved useful in overseeing the broker-dealer industry, in our view supervision in the broker-dealer context serves fundamentally different purposes than supervision in auditing.

Strict supervision is needed for broker-dealers because in certain important respects the economic interests of broker-dealers and their customers may be in conflict. Broker-dealers generate a significant portion of their revenues by purchasing and selling securities for their customers, and their compensation structure may incentivize them to recommend transactions that may not be suitable for their clients. As a check, broker-dealers are required to have supervisory procedures in place and enforce them for every aspect of their business in order to prevent illegal conduct. Such incentives are not present in the auditing profession. Moreover, the activities of audit engagement teams involve the extensive exercise of professional judgment, unlike in the broker-dealer situation, and the motivations of members of engagement teams are different from those in the broker-dealer context.

NASD Rule 3010, which governs broker-dealer supervision, spells out a litany of detailed and ministerial supervisory requirements that are inconsistent with the nature of supervision effected by registered public accounting firms and their personnel in fulfilling their respective obligations pursuant to the Board's professional standards. We believe Rule 3010's detailed supervisory requirements are unnecessary in order to have registered public accounting firms appropriately supervise their personnel so that they perform audits in accordance with the Board's professional standards.

While the SEC also has brought cases against senior officers, compliance department personnel and other supervisors for failure to supervise, these cases tend to involve situations where serious wrongdoing went undetected or red flags were ignored by supervisory officials. See, e.g., *In re Patricia A. Johnson* (suspension of branch manager who failed reasonably to supervise a broker in her office who had misappropriated customer funds) <sup>7</sup>; *In re Gutfreund* (senior officials of Salomon Brothers failed to investigate activities of a senior bond trader who had submitted false bids in a U.S. government treasury auction)<sup>8</sup>.

While there might be occasions for failure to supervise enforcement cases, these are exceptional cases involving egregious circumstances. In any event, the absence of a rule that assigns specific responsibilities and tasks to specific senior officials does not appear to be a prerequisite to the use of

<sup>6</sup> SEC Practice Section Requirements of Membership 1008.08(f) was superseded by Auditing Standard No. 7, *Engagement Quality Review*; SEC action January 15, 2010; SEC Release No. 34-61363. See [http://pcaobus.org/Standards/Auditing/Pages/Auditing\\_Standard\\_7.aspx](http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_7.aspx).

<sup>7</sup> SEC Release No. 34-35698 (May 10, 1995), reversed on other grounds sub nom., *SEC v. Johnson*, 87 F.3d 484 (D.C. Cir. 1996).

<sup>8</sup> SEC Release No. 34-31554 (December 3, 1992).



this statutory provision. We believe that this assessment supports our view regarding PCAOB rulemaking in this area; and that in any event, Section 15(b)(4)(E) of the Securities Exchange Act of 1934 does not provide an appropriate model for the PCAOB's very different oversight function.

4. If the PCAOB decides to move forward with rulemaking, we urge the proposal of a rule that, in general terms, would require 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 unique quality control and operational structures, 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 require assignment of responsibility and documentation of that assignment," would be a more appropriate approach. 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, consistent with a firm's obligations under the Board's quality control standards. The proposed requirements should not be presented in the form of a checklist of requirements, but rather, a collection of guiding principles.

We do not support the more detailed alternative approach and believe proposed requirements should avoid, for example, the inclusion of positions or job titles specifically tied to individual quality control elements or prescribing a specific reporting hierarchy. We are concerned that if requirements are too detailed: (1) they may inadvertently drive firm organizational structures, as opposed to allowing individual firms to assess their audit practices and implement appropriate quality control policies and procedures; (2) they may not adequately accommodate the broad diversity of firm structures, practices and policies; and (3) they may stifle creation or development by firms of approaches to most effectively accomplish the overall objectives of an audit quality control system.

In formulating a view as to whether and how the Board will pursue future rulemaking, we caution the Board to take care so that the requirements do not result in unintended consequences; for example, discouraging professionals from participating in consultations or, particularly at smaller firms, discouraging personnel from assuming quality control responsibilities (given the limited resources of a smaller firm), for fear of being considered "supervisory personnel" for purposes of Section 105(c)(6), which we believe would have a detrimental impact on audit quality.

Finally, we reiterate our view that given that existing quality control standards (QC 20, 30, and 40) work to foster an audit quality control system that supports effective and appropriate supervision, we believe that if the Board determines it is appropriate to establish requirements for firms to "make and

document clear assignments of supervision responsibilities that are already an element of their audit practice,” such requirements should be embedded in the Board’s quality control standards.

5. As a final matter, we draw the Board’s attention to several issues relative to statutory interpretation and definitional clarification; these issues relate to matters that are largely set forth in Part I of the Concept Release.

First, Section 105(c)(6) provides that the Board may impose sanctions on a registered firm or on the “supervisory personnel” of a registered firm, if the Board finds that, in part, “the firm has failed reasonably to supervise an associated person, either as required by the rules of the Board relating to auditing or quality control standards, or otherwise, . . .” [Emphasis added]. According to the Release on page 4, “the range of conduct that the Board might address through the ‘or otherwise’ clause encompasses conduct not covered by any supervision rules or standards. . . . The Board’s authority to impose sanctions is found only in section 105(c)(6) and involves case-by-case determinations concerning the reasonableness of supervision in particular circumstances, without regard to whether any specific supervision rules or standards are implicated.” Interpreting the phrase, “or otherwise,” as encompassing failure to supervise liability for *any* conduct extending beyond a supervision rule or standard effectively would decouple liability from *any* rule or standard. We are not convinced this is what Congress intended when enacting failure to supervise liability, and would be a grant of authority much greater than that found in the core liability provision of the statute. Instead, we believe Section 105(c)(6) should be interpreted to be tied to existing rules and standards applicable to auditing, and thus to apply only to the Board’s supervision rules or standards, or as otherwise required by other rules and standards of the Board or the relevant professional standards.

Second, the Board emphasizes in its Release that there is “no reason. . . to limit the persons who may have supervisory liability to those occupying certain positions.” The CAQ agrees that supervisory liability should not be based on titles alone. An examination of “the nature of their responsibility, ability, or authority in relation to the conduct of the associated person who commits a predicate violation” (page 6 of the Release), is essential to identifying supervisory personnel for purposes of Section 105(c)(6) liability.

Further, the Release states that, “whether a sufficient connection exists between unreasonable supervisory conduct and a particular predicate violation to warrant the imposition of sanctions pursuant to section 105(c)(6) . . . will depend on the specific facts and circumstances.” [Emphasis added.] The Board recognizes the need for a “sufficient connection” to a predicate violation, which we believe requires the presence of a nexus between the exercise of supervisory responsibility and the associated person and predicate violation of standards or law, with respect to the audit at issue.

The nexus requirement should work hand-in-hand with the functional definition of “supervisory personnel” discussed above to help ensure that failure to supervise liability under Section 105(c)(6) is properly allocated. Individuals who are subject to failure to supervise liability ordinarily would not extend beyond engagement team personnel. As such, others within a firm, among whom would be found individuals identified in any hierarchy of those having responsibilities for the implementation of quality control functions, ordinarily should be outside the reach of Section 105(c)(6).

In this regard, requirements that the Board might impose for the making and documenting of assignments of responsibilities relating to quality control functions cannot themselves be the basis for imposing Section 105(c)(6) failure to supervise liability. Consequently, we believe any such documentation must be used with caution. Although we do not believe it is the Board's intention, we caution that such documentation should not be a roadmap for allocating Section 105(c)(6) liability and should not be misapplied in an enforcement or litigation context.

Finally, with regard to the Safe Harbor Provision of Section 105(c)(6)(B), the Release recognizes that Section 105(c)(6) "does not create a form of strict 'failure to supervise' liability for the firm or supervisory personnel just because an associated person has committed a violation." The Release, however, characterizes the statutory safe harbor provision, Section 105(c)(6)(B), as an "affirmative defense." We think this is incorrect.

The safe harbor provision is understood as a rule of construction—essentially an element for establishing liability under Section 105(c)(6). The text of the statute makes clear that the Board shall not deem any person to have violated the statute if the safe harbor conditions are met—i.e., the burden to resolve that question is on the Board.

The Release suggests that "it is not necessary for the Board affirmatively to find, as an element supporting the imposition of sanctions, that one or more of the three elements described above [in Section 105(c)(6)(B)] was not satisfied." This approach would shift the responsibility from the Board to the respondent. Section 105 generally serves as a grant of statutory authority for the Board to engage in "investigations and disciplinary proceedings." Thus the mandates of the statutory text apply to the Board, and the Board "shall not deem" any person to have failed to have reasonably supervised if the safe harbor conditions are met. We believe that the Board, not the respondent, has the burden of proof under this provision.

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The CAQ appreciates the opportunity to comment on the Concept Release and would welcome the opportunity to respond to any questions you may have regarding any of the comments and recommendations included in this letter.

Sincerely,



Cindy Fornelli  
Executive Director  
Center for Audit Quality



cc: PCAOB

Daniel L. Goelzer, Acting Chairman

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