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PCAOB Floats Auditor Quality Control Reforms

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By David Isenberg | November 29, 2022

The **Public Company Accounting Oversight Board** has proposed changes to its quality control standard for auditors for the first time in 20 years.

The current approach, put in place after the Sarbanes-Oxley Act was passed in 2002, was intended to be temporary and governs the standards of conduct by which audit firms hold themselves. The PCAOB floated the replacement rule during a Nov. 18 board meeting.

The rule would require audit firms to publicly disclose their quality control policies and procedures. They would also have to complete nonpublic disclosures to the board. If passed, the rule would also enhance an auditor's duties to respond to deficiencies on already completed engagements.

The proposal is designed to be more flexible and include more granular requirements, said **Amy Jane Longo**, partner at **Ropes & Gray**.

The updated quality control standards aim to prevent audit failures and erroneous audit reports, and would require continuous audit quality monitoring and improvement, said **Kara Stein**, a PCAOB board member, during the open meeting. Stein also served as a commissioner at the **Securities and Exchange Commission** from 2013 to 2019.

The proposal would for the first time require an audit firm's system of quality control to reflect and reinforce the firm's role "in protecting the interests of investors and furthering the public interest in the preparation of informative, accurate, and independent audit reports," it says.

Investors are the primary consumers of audits because they have no control over the process and bear the grave consequences of poor audit quality, noted **Christina Ho**, another PCAOB board member, during the meeting.

"Asset managers are among the stakeholders who rely on the importance of rigorous audits, faithfully executed in accordance with professional standards of ethics and independence," Longo said.

Ineffective quality control systems put investors at risk, said PCAOB Chair **Erica Williams**.

The proposal would be less uniform and prescriptive than the current standard for quality control, said **James Tierney**, a law professor at **Nebraska College of Law** and a former senior counsel at the SEC's Office of the General Counsel. The prior version doesn't account for technological developments such as IT departments, and it focuses less on the actual risk and actual functionality of the specific audit firm.

“Under the current rule, an audit firm’s quality control systems are supposed to provide reasonable assurances that a firm’s personnel are complying with applicable professional standards and the firm’s standards of quality,” he said.

The proposed changes enshrine the auditors’ mission to protect the firm they inspect as well as the public at large, said **Duane DesParte**, a PCAOB board member.

The floated changes also expand what activity and occasions trigger the audit standards, Tierney said. For example, the current standard only covers financial statement audits, not internal control over financial reporting, or ICFR, audits.

The more principles-based approach in the proposal is more investor-friendly because it ensures that audit firms have more holistic approaches to preventing conflicts with management, Tierney said.

“To the extent that the proposed standard tried to shift toward this more risk-based approach, it’s focusing more on this idea that we live in this world of complexity and one-size-fits-all solutions might not work,” he added. “To the extent that the system of investor confidence that underlies securities regulation depends on trustworthy or reliable auditors’ reports, then making sure that we have a robust system of ensuring quality in that process of generating auditor reports is critical to the whole system.”

The proposed standard is more scalable for firms, regardless of their size, Longo said.

“The scalable approach would allow firms to tailor the design of their quality control systems based on the characteristics and risks of their specific practices,” DesParte said at the Nov. 18 meeting.

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The proposal also requires audit firms to continuously surveil the firms they audit, and it also introduces new, enhanced ethics and integrity standards for the auditors, the proposal says.

It also introduces new liability standards for the audit firm’s chief executive and ensures that those who conduct key audit functions report directly to that person, the proposal says.

Audit firms that conduct over 100 audits a year would also need to provide additional oversight and surveillance of firm activity, the proposal says. They would also be required to maintain an independent oversight system for their quality controls.

SEC Chair **Gary Gensler** asked the PCAOB and SEC staff in August to tighten auditor independence rules. At the time, he said that the standards governing auditor independence from other business lines like consulting could create conflicts of interest, and must be reformed.

Last year, the SEC fired the PCAOB chair and several board members appointed by former SEC Chair **Jay Clayton**. Clayton made a similar move in 2017 after revelations surfaced that the board leaked confidential inspection plans to **KPMG**.

The Clayton-appointed PCAOB board had far fewer enforcement actions than prior administrations, according to Senators **Bernie Sanders** (I-Vt.) and **Elizabeth Warren** (D-Mass.), who claimed that the board "compromised the PCAOB's independence, weakened its expertise, and reinforced perceptions of its capture by industry."

The current market environment and the fallout of **FTX** – which was audited by two firms, **Armanino** and **Prager Metis** – demonstrates why audit firms' quality controls are crucial, Tierney said.

"What appeared to be the total lack of internal controls at FTX revealed in the last few weeks illustrates to both investors, creditors, and other participants … the importance that the financials are what they say they are," he said.

The PCAOB will accept comments on its proposed quality control rule until Feb. 1.

At the same meeting where the PCAOB proposed revamping the quality control standards, it also unveiled a five-year plan and requested a 12.65% budget increase for 2023, to $349.5 million. In 2022, its budget was $310.3 million, and in 2021, it was $264.4 million.

In the budget proposal, the PCAOB requests a 9.8% increase in funding, or $155 million, for the Division of Registration and Inspections. It also wants a $23 million budget for its Division of Enforcement and Investigations, a 15.3% increase from this year's allotment.

PCAOB could be asking for more money for those units because it is attempting to be more assertive and levy more significant penalties, Ropes & Gray's Longo said.

The budget would also for the first time earmark money for an Office of the Investor Advocate. The office would be granted a budget of $738,000 for 2023. The office previously existed but had never received funding.

Also at the Nov. 18 meeting, the PCAOB unveiled its strategic plan for 2022 through 2026, which includes four goals: modernizing standards, enhancing inspections, strengthening enforcement and improving organizational effectiveness.

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