

**Consumer Federation of America
AFL-CIO
Better Markets
Center for American Progress
Americans for Financial Reform**

November 21, 2018

Dear Chairman Clayton:

We are writing to express our grave concerns regarding PCAOB staff guidance on Rule 3526(b), Communications with Audit Committees Concerning Independence, which was published earlier this year. The faulty interpretation of the rules contained in this staff guidance would both undermine auditor independence and deceive the investing public by permitting firms to claim an audit was independent and conducted in accordance with PCAOB standards even when violations of the auditor independence rules occurred. We therefore urge you to require the PCAOB to withdraw this guidance immediately and to affirm that the position adopted by PCAOB in this guidance is inconsistent with SEC policy and federal securities laws.

The independence of public company audits is what gives them value. It is what allows investors to rely on companies' financial statements as accurate and reliable when making investment decisions. As such, auditor independence is critical to both the integrity and the efficiency of our capital markets. Recognizing the central importance of auditor independence, PCAOB Rule 3520 requires an audit firm and its associated persons to maintain their independence *throughout* the audit and professional engagement period, by satisfying the independence criteria of both the SEC and the PCAOB.

Unfortunately, audit firm compliance with this most basic of obligations has been inconsistent at best. In its Inspections Outlook for 2019, for example, PCAOB states: "Over the last several years, we have identified recurring deficiencies related to auditor independence, including firms' monitoring procedures failing to identify independence violations. 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."¹

Indeed, the staff guidance in question was adopted because of the frequency with which PCAOB inspection staff encountered situations in which auditors had affirmed their independence despite having violated one or more independence rules during the course of an audit. Instead of taking action to address these deceptive claims, the PCAOB staff guidance seeks to paper them over, as long as the audit firm and the board audit committee have a plan for addressing the independence violation and decide between them that the audit wasn't compromised. It should go without saying that both the audit firm and the board have strong incentives to keep any such problems under wraps.

¹ PCAOB, Inspections Outlook for 2019, Dec. 6, 2018, <https://pcaobus.org/Inspections/Documents/Inspections-Outlook-for-2019.pdf>.

This goes far beyond the limited leeway provided under SEC rules for “inadvertent” violations. Under the SEC rules, an audit firm that has inadvertently violated SEC independence rules will not be determined to have violated the auditor independence rules, if and only if: “(1) The covered person did not know of the circumstances giving rise to the lack of independence; (2) The covered person’s lack of independence was corrected as promptly as possible under the relevant circumstances after the covered person or accounting firm became aware of it; and (3) The accounting firm has a quality control system in place that provides reasonable assurance [and] ... that covers at least all employees and associated entities of the accounting firm participating in the engagement.” In contrast, the PCAOB staff guidance is not limited to inadvertent violations and does not impose the same obligations with regard to prompt correction or rigorous quality controls.

PCAOB Has Adopted an Approach to Auditor Independence that the SEC Has Rejected

The SEC has in the past explicitly rejected the approach outlined in the PCAOB staff guidance. In November of 2000, the agency adopted revisions to its auditor independence rules over the strenuous objections of some audit firms.² With regard to employee relationship rules, for example, some commenters, including audit firm representatives, specifically suggested that the Commission adopt the approach outlined in Independence Standards Board (ISB) standards, which stated: “An audit firm's independence is impaired with respect to an audit client that employs a former firm professional who could, by reason of his or her knowledge of and relationships with the audit firm, adversely influence the quality or effectiveness of the audit, *unless the firm has taken steps that effectively eliminate such risk.*” (Emphasis added)

In rejecting this approach, the Commission stated, “In our view, independence is better assured by consistent and uniform rules, rather than by rules that rely on the auditor's assessment of the extent of its own self-interest. Furthermore, it has been our experience that the existence of safeguards or quality controls alone does not ensure compliance with even the most basic independence regulations.”

Similarly, some commenters had urged the Commission to rely primarily on corporate audit committees to monitor and ensure auditor independence. But the Commission rejected this approach as well, stating: “While we welcome active oversight by audit committees with respect to auditor independence, we do not believe that this oversight obviates the need for the rule we adopt today. Audit committees bring business judgment to bear on the financial matters within their purview. Their purpose is not to set the independence standards for the profession, and we are not attempting to saddle them with that responsibility.”

The Commission made clear that the determination of whether or not an auditor will be considered independent is based on the perspective of an informed investor, not the perspective of the auditor or the audit committee. The SEC stated, for example, that the issue in determining independence “is whether providing these services makes it unacceptably likely that there will be an effect on the auditor's judgment, *whether or not the auditor is aware of it.*” And it further

² Securities and Exchange Commission, Final Rule: Revision of the Commission’s Auditor Independence Requirements, File No. S7-13-00, Nov. 21, 2000, <https://www.sec.gov/rules/final/33-7919.htm>.

noted that the purpose of the rule revisions was to identify those circumstances in which “it is sufficiently likely that an auditor’s capacity for objective judgment will be impaired or that the *investing public will believe* that there has been an impairment of independence.” (Emphasis added)

In short, the PCAOB staff guidance directly conflicts with the position taken by the SEC with regard to the standard for determining independence, the role of audit committees in determining auditor independence, and the adequacy of “safeguards” to cure independence violations.

PCAOB’s Guidance Would Result in Investor Deception

Under the staff guidance, audit firms that violate independence rules wouldn’t even be required to make any changes to the wording of the audit report to acknowledge the independence violations. The report could still be titled “Report of Independent Registered Accounting Firm.” And it would still include affirmative statements both that the audit was conducted in accordance with the standards of the PCAOB and that the auditor “is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB.”

As a result, not only will investors not have independence violations brought to their attention, under this approach, they will be misled into believing that no such violations occurred. As such, this approach not only substitutes the judgment of the audit firm and audit committee for the judgment of the investing public, it denies investors an opportunity to reach an independent judgment. This violates the most basic principles of transparency underlying our securities markets. As a pension fund representative commented during the 2000 rulemaking, “While we do not believe that disclosure in and of itself is adequate to deal with the independence problems involved here, shareholders have a right to know about relationships that may compromise the independence of audits on which they rely.”

PCAOB Guidance Was Adopted through an Opaque, Closed Process

In contrast with the SEC independence rules, which were adopted in compliance with the Administrative Procedure Act, the staff guidance process through which this anti-investor policy was adopted is deeply problematic. It is true that, in the Sarbanes-Oxley Act, Congress gave the SEC and PCAOB the ability to waive independence standards, but only on a specific registrant-by-registrant basis, where there is a finding that the waiver is in the best interests of investors, and only if they follow the normal rule making process. The PCAOB followed no such process and reached no such finding.

Moreover, while the PCAOB may not be subject to the President’s recent Executive Order on Promoting the Rule of Law Through Improved Agency Guidance Documents, this staff guidance certainly violates the spirit of that order. An issue of this magnitude should only be dealt with through a transparent rulemaking process that allows ample opportunity for all stakeholders to be heard. The PCAOB’s decision to rely instead on staff guidance is all the more problematic: 1) because the guidance was innocuously labeled as involving audit firm communications with audit committees, rather than the fundamental revision of auditor independence rules it actually

provides; and 2) because of reports that the PCAOB received a white paper from the audit firms on this topic some years ago, which the PCAOB has refused to make public. That suggests that audit firms have been given an opportunity to influence policy in a way that other stakeholders, including investors, have not.

The SEC Must Reject This Anti-Investor Guidance

The PCAOB staff guidance does make clear that it does not address whether the SEC will accept financial statements with a report from an auditor that has violated the independence rules, in circumstances where the audit firm and audit committee believe the objectivity and impartiality of the auditor have not been impaired. A recent enforcement action by the SEC against PricewaterhouseCoopers LLC suggests that the agency, to its credit, may not share the PCAOB's lax view of firms' independence obligations.³ In that action, the agency sanctioned PwC both for its independence violations involving a series of audits *and* for representing that it was independent in an audit report affected by the violations. Unfortunately, the fact that the SEC has allowed the PCAOB staff guidance to go unchallenged calls into question the SEC's commitment to maintaining this pro-investor interpretation.

We, therefore, urge you to clarify that this will continue to be the agency's approach on the issue. To achieve that clarification, the SEC should at a minimum require the PCAOB to immediately withdraw the staff guidance. In its place, to the degree that any revisions to the rules are necessary, the SEC should request the PCAOB to undertake rulemaking in accordance with the Administrative Procedure Act to address this important issue. That process should go through the normal rulemaking process, including a robust opportunity for public comment. In order to ensure that investors are not deceived regarding the independence of the audit, the SEC should require the following disclosures when an auditor has violated the independence standards established by Congress, the SEC and/or the PCAOB.

- The audit committee should be required to disclose to investors:
 - The nature of the independence violation and for what time period it existed.
 - The audit committee's plan for addressing and resolving the violation and how the plan is in the best interests of the shareholders.
 - The basis for the conclusion by the audit committee that the auditor's infraction did not violate the applicable independence rule.
- The auditor should be required to disclose in the auditor's report to shareholders:
 - The basis for the conclusion by the auditor that the infraction did not impair the auditor's independence.
 - Steps the auditor has taken to remediate the infraction, including any breakdown in internal quality controls.
 - Whether or not the lead and/or review partner on the audit were aware of the violation during the course of the audit.

³ Securities and Exchange Commission, Accounting and Auditing Enforcement Release No. 4084, In the Matter of PricewaterhouseCoopers LLP, Respondent, Sept. 23, 2019, <https://www.sec.gov/litigation/admin/2019/34-87052.pdf>.

SEC Action is Needed to Restore Investor Confidence in the Integrity of Financial Reports

Audit firms have over the years strenuously resisted strong auditor independence rules. When, prior to Enron, the SEC was looking to strengthen to independence standards, audit firms went so far as to enlist members of Congress to threaten the SEC's funding if it proceeded with the rulemaking. After Enron, both when Congress was taking additional steps to reinforce the independence standards and when the SEC was engaged in rulemaking to implement those rules, audit firms were back in action, seeking to water down the requirements. This staff guidance sends the disturbing message that their decades-long efforts to escape accountability for meeting basic independence standards necessary to the credibility of the audit has found a ready audience at the PCAOB. To restore investor confidence in the reliability of corporate financial disclosures, the staff guidance must be withdrawn immediately and replaced by a new pro-investor standard, adopted through the normal rulemaking process.

Thank you for your attention to our concerns.

Respectfully submitted,

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cc: The Honorable Robert J. Jackson, Commissioner
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The Honorable Elad L. Roisman, Commissioner
The Honorable Allison Herren Lee, Commissioner
The Honorable William D. Duhnke III, Chair, PCAOB
The Honorable J. Robert Brown, Jr, Board Member, PCAOB

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The Honorable Mike Crapo, Chairman, Senate Banking Committee
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