

December 16, 2020

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE, Washington, DC 20549-1090

Re: File No. PCAOB-2020-01, Revisions to Auditor Independence Standards¹

Dear Secretary Countryman:

We are writing on behalf of the undersigned organizations and individuals to express our strong opposition to the PCAOB's proposal to revise its auditor independence rules to align them with recent SEC rule changes. Like the SEC rules on which they are based, these changes would weaken auditor independence standards, further undermining investors' faith in the reliability of financial disclosures and putting the integrity of our capital markets at risk. In a gross abuse of process, these changes were adopted by the PCAOB without any opportunity for public comment and without any apparent consideration of how they will affect communications between auditors and audit committees. They are now being hurried through the approval process at the SEC under an artificially short timeframe. For these and other reasons discussed below, the rule changes should be withdrawn.

- 1) SEC and PCAOB should strengthen, rather than weaken, auditor independence standards.

As the SEC itself used to emphasize, our markets depend on "the steady flow of timely, comprehensive, and accurate information," which results in "a far more active, efficient, and transparent capital market that facilitates the capital formation so important to our nation's economy."² Auditors have a central, and lucrative, role to play in ensuring the accuracy of the financial information that companies are required to report. But, with auditors paid and supervised by the companies they audit, investors can only trust in the reliability of those financial statements if the auditor maintains its independence, to the extent possible within this conflicted business model, and approaches the audit with an appropriate degree of professional skepticism. Time and again, auditors have failed to live up to this standard, and investors have paid the price. Even after Congress stepped in, in the wake of massive accounting scandals at

¹ Public Company Accounting Oversight Board, Notice of Filing of Proposed Rules on Amendments to PCAOB Interim Independence Standards and PCAOB Rules To Align With Amendments to Rule 2-01 of Regulation S-X (Nov. 20, 2020), <https://www.sec.gov/rules/pcaob/2020/34-90473.pdf>.

² CFA Comment Letter, regarding Amendments to Rule 2-01, Qualifications of Accountants (May 4, 2020), <https://www.sec.gov/comments/s7-26-19/s72619-7146025-216304.pdf> (citing to the What We Do section of the SEC website, <https://www.sec.gov/Article/whatwedo.html>). It is perhaps not a coincidence that this section of the website has since been revised in a way that deemphasizes the importance of transparency to efficient capital formation.

Enron, Worldcom, and many others, and passed sweeping legislation to address the problem, the SEC and the PCAOB have too often proven timid and ineffective in implementing and enforcing that legislation. As a result, the twin goals of strengthened auditor independence and oversight have gone largely unrealized.³

That regulatory failure shows in the quality of public company audits. A review of recent PCAOB inspection reports shows, for example, that staff members routinely find deficiencies related to auditor independence and professional skepticism, two cornerstones of an effective audit. As the Board indicated in its December 2018 Staff Inspection Brief, “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.”⁴ Violations found at both the largest firms and at smaller firms have included: a failure to have adequate systems in place to provide investors with confidence that the audit firm was in fact complying with the independence rules; and evidence that auditors were misleading audit committees by failing to provide them with the information they need to make informed decisions. In a related matter, inspection staff also “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.”⁵ In other words, where skepticism is most needed, auditors are too often falling down on the job.

Those failures have not gone unnoticed. As Commissioners Allison Herren Lee and Caroline A. Crenshaw noted in their public statement opposing the most recent round of auditor independence rule changes at the SEC, auditors, whose role is to promote public trust in our markets, now themselves face a “crisis of trust.”⁶ History tells us that, under these circumstances,

³ See, e.g., David R. Hilzenrath, Project on Government Oversight, Botched Audits: Big Four Accounting Firms Fail Many Inspections (Sep. 5, 2019), <https://bit.ly/33TUHdo>; Hilzenrath and Nicholas Trevino, POGO, How an Agency You’ve Never Heard of Is Leaving the Economy at Risk (Sep. 5, 2019), <https://bit.ly/3mTH6Km>.

⁴ Inspections Outlook for 2019, Staff Inspection Brief, December 6, 2018, <https://pcaobus.org/Inspections/Documents/Inspections-Outlook-for-2019.pdf>. See also, PCAOB Staff Inspection Brief, Vol. 2016/3, July 2016, <https://pcaobus.org/Inspections/Documents/Inspection-Brief-2016-3-Issuers.pdf> (“Deficiencies observed in 2015 included instances in which some auditors provided impermissible non-audit services during the period under audit, and instances in which auditors did not obtain pre-approval from the audit committee prior to performing non-audit services.”); PCAOB Staff Inspection Brief, Vol. 2017/4, November 2017, <https://pcaobus.org/Inspections/Documents/inspection-brief-2017-4-issuer-results.pdf> (“Inspections staff continued to identify deficiencies related to non-compliance with PCAOB rules and/or SEC rules and regulations related to auditor independence. Examples include instances in which auditors: ...conclude[d] inappropriately that a covered person’s lack of independence ... had not resulted in impairment of the firm’s independence; ... Entered into agreements through which their audit client agreed to indemnify the auditor against any liability or expense arising out of the engagement; Provided impermissible non-audit services during the period under audit ... Some deficiencies were also identified that indicated certain firms did not have a quality control system that provided sufficient assurance that outside firms or auditors involved in issuer audit engagements or the firm’s personnel were in compliance with the independence requirements.”).

⁵ Staff Inspection Brief 2016. (“For example, Inspections staff continues to observe situations in which auditors seek to obtain only evidence that would support significant judgments or representations made by management, rather than to critically assess the reasonableness of management’s judgments or representations, taking into account all relevant evidence, regardless of whether it confirmed or contradicted management’s assertions.”)

⁶ Commissioner Allison Herren Lee and Commissioner Caroline A. Crenshaw, Who Watches the Watchers? Joint Statement on Auditor Independence Amendments (Oct. 16, 2010), <https://www.sec.gov/news/public-statement/lee->

it is only a matter of time before auditors' failure to faithfully fulfill their gatekeeper function, and the SEC and PCAOB's apparent reluctance to hold them accountable for those failures, once again come to a head in a rash of corporate scandals. Such scandals are damaging to investors, to the public's faith in the integrity of our markets, and, by extension, to the issuers who rely on those markets to raise capital.

- 2) Both the SEC's recent amendments, adopted with two dissents, and the PCAOB rule changes to align with the SEC rules would weaken, rather than strengthen, auditor independence.

Instead of acting to address that problem, the leadership of the SEC and PCAOB, between them, have been engaged in a systematic weakening of those critically important auditor independence standards. That has included:

- SEC action, in its 2019 rule changes, to narrow the definition of audit client for a fund under audit to exclude funds that would otherwise be considered "affiliates of the audit client" and to replace a bright-line 10% shareholder ownership test for debtor-creditor relationships with a weaker, harder to enforce 20% "significant influence" test.⁷
- SEC action, in its 2020 rule changes, to add a "materiality qualifier" to the definition of audit client, relying on audit firms and audit clients to decide whether something is likely to compromise auditor independence and removing the oversight regarding those determinations previously provided by Commission staff.⁸ This is akin to parking the Fox in the Hen House. It ignores both the PCAOB's own evidence of rampant non-compliance with auditor independence rules and the obvious conflict of interest auditors and audit clients face in making those determinations.
- SEC action, in its 2020 rule changes, to shorten the look-back period for domestic first-time filers to the most recently completed fiscal year. This approach threatens to undermine the quality and reliability of financial reporting by first-time issuers. It was adopted despite evidence of increased risks in the IPOs of so-called "unicorns," which too often suffer from inadequate corporate governance and lax accounting practices.⁹
- PCAOB action in 2018 adopting guidance regarding auditor communications with audit committees that undermines compliance with auditor independence rules by permitting firms to falsely claim an audit was independent and conducted in accordance with

[crenshaw-who-watches-watchers](#) (citing Karthik Ramanna, Building a Culture of Challenge in Audit Firms, (Sept. 2019), <https://www.pwc.co.uk/who-we-are/future-of-audit/building-a-culture-of-challenge-in-audit-firms.pdf>.)

⁷ Council of Institutional Investors Comment Letter regarding File No. S7-10-18: Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships (Jun. 28, 2018), <https://www.sec.gov/comments/s7-10-18/s71018-3969965-167120.pdf>.

⁸ See, CFA Comment Letter regarding Amendments to Rule 2-01, Qualifications of Accountants (May 4, 2020), <https://www.sec.gov/comments/s7-26-19/s72619-7146025-216304.pdf> for a more detailed discussion of our concerns.

⁹ *Id.* (citing Renee M. Jones, The Unicorn Governance Trap, 66 U. Pa. L. Rev. Online 165 (2017), <http://bit.ly/2msD01w>).

PCAOB standards when violations of the auditor independence rules have occurred.¹⁰ By the PCAOB's own admission, the guidance 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 those deceptive claims, the PCAOB staff guidance papers them over. And, like the rules currently before the SEC for approval, that guidance was adopted through an opaque process from which investors were excluded.

As Commissioners Lee and Crenshaw stated in their public statement on the latest SEC rule changes, "the dial for auditor independence is turning in only one direction, and that is towards loosening standards and reducing transparency."¹¹ Worse, this loosening of the standards is occurring at the same time the quality of audits and compliance with professional standards have fallen to dangerously low levels, as noted in PCAOB inspection reports.

3) The PCAOB changes suffer from additional serious deficiencies.

The PCAOB rule changes, like the SEC rules on which they are based, place significant responsibility on auditors and audit committees to determine whether certain relationships are "material" and thus likely to impact their objectivity. They have adopted this approach despite the concerns previously expressed by PCAOB inspection staff 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." Those determinations have only been made more difficult as a result of the recent SEC rule changes, which place much greater reliance on auditors' exercising judgement. And yet PCAOB has failed to include any provisions in its rules to enable either audit committees or PCAOB inspection staff to provide the oversight needed to ensure those determinations are appropriate.

The PCAOB has particular responsibility for overseeing the communications of auditors with audit committees, including with regard to auditor independence. As PCAOB Board Member J. Robert Brown, Jr. noted in his statement opposing these rule changes, the rules of the PCAOB recognize the importance of this audit committee responsibility for oversight of auditor independence by requiring "that audit firms continually evaluate their independence and communicate to audit committees any relationship that may bear on this issue."¹² Brown voiced concern that, despite the fact that the changes will allow audit firms to engage in an expanded set of services to some affiliates of their audit clients, services that the PCAOB itself acknowledges could result in independence concerns, "The Board is silent about what, if anything, and when, if ever, audit firms should communicate these matters to audit committees. The result may be that

¹⁰ Letter from CFA, AFL-CIO, Better Markets, Center for American Progress, and Americans for Financial Reform to SEC Chairman Jay Clayton (Nov. 21, 2018), <https://consumerfed.org/wp-content/uploads/2020/03/Letter-to-SEC-on-PCAOB-aud-ind-guidance-11.21.19.pdf>. (Group Letter)

¹¹ Who Watches the Watchers?

¹² J. Robert Brown, Jr., PCAOB Board Member, Reducing PCAOB Authority over Auditor Independence, Statement at PCAOB Open Board Meeting (Nov. 19, 2020), <https://pcaobus.org/news-events/speeches/speech-detail/reducing-pcaob-authority-over-auditor-independence>.

directors will not receive information highly relevant to their oversight responsibilities.”¹³ We share that concern.

Similarly, we share Brown’s concern that the failure to include any documentation requirement could seriously undermine PCAOB’s ability to assess both risks to the auditor’s objectivity and impartiality and auditors’ compliance with federal regulations and PCAOB standards and rules. As Brown stated, “The ability to conduct this assessment may be compromised where firms do not adequately document their determinations.” And yet, Brown added, “The topic of documentation is missing from what the majority approves today. Nothing in the release speaks to whether firms should document their assessment of, and conclusions about, the immateriality of client affiliates, the effect of such a determination on a firm’s risk assessment, their determination that an independence violation was ‘inadvertent’ or that an ‘inadvertent’ violation could not be addressed prior to the client merger.”¹⁴ This is a major oversight that must be corrected in keeping with the PCAOB’s own standard on audit documentation.¹⁵

Before the rule moves forward, the PCAOB should, at the very least, add provisions related to auditors’ required communications with audit committees and their obligations to document their determinations. The SEC should therefore reject this rule change until this major gap in the regulation is corrected.

4) The process the PCAOB used to adopt these changes is grossly deficient.

As has become all too common in recent years, these rule changes were adopted by the current members of the PCAOB without any opportunity for input from investors or other stakeholders and without any analysis of its economic impact.¹⁶ As PCAOB Board Member Brown noted in his statement of opposition, “The decision to dispense with the views of investors, audit committees, audit firms, and the public does not comport with the PCAOB’s mission, is not compelled by exigent circumstances, and is another example of an unfortunate trend of reducing investor and public input in the PCAOB decision-making process.” The only justification offered by the Board for this extraordinary departure from regulatory norms is that the SEC, in revising its own rules, had solicited public comment and included an economic analysis.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ The PCAOB’s Auditing Standard AS 1215, “Audit Documentation,” states that the auditor must document the procedures performed, evidence obtained, and conclusions reached. The documentation must clearly demonstrate the work was in fact performed and contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the conclusions reached. Yet the PCAOB’s proposed rulemaking provides an exception to the standard for the single most important conclusion reached during the course of the audit – that the auditor is in fact, and is perceived as, being independent. This in turn raises a question about the serious lack of quality and diligence in this rulemaking process.

¹⁶ This is entirely inconsistent with Chairman Duhnke’s professed commitment to transparency and outreach. *See, e.g.,* William D. Duhnke III, PCAOB Chairman, Keynote Speech at the 14th Annual Audit Conference, Baruch College, as published by the Harvard Law School Forum on Corporate Governance (Dec. 6, 2019), <https://corpgov.law.harvard.edu/2019/12/06/keynote-speech-by-pcaob-chairman-william-d-duhnke-iii-at-14th-annual-audit-conference-baruch-college/>.

This baseless justification ignores the PCAOB’s separate authority to adopt auditor independence standards and its responsibility to ensure that any standards it adopts fulfill its obligation to act “in the public interest or for the protection of investors.” In giving it that independent authority, Congress clearly expected the Board to do more than simply rubberstamp SEC rules without conducting any separate inquiry. Moreover, as noted above, the PCAOB has particular responsibility to set standards for auditors’ communications with audit committees. It therefore has an obligation to consider how these auditor independence rules changes affect those related rules, something it has failed to do.

In its Release, the Board seeks to further suggest that the decision to adopt the rule changes outside the normal standard-setting process is justified because the rules themselves are non-controversial. It states, for example, that “After receiving public comments on the proposals, many of which broadly supported the objective of the proposed amendments or were generally in favor of the proposals, the Commission then adopted the amendments largely as proposed.” But the reaction to the SEC rules is not as generally favorable as it seeks to suggest. In fact, the favorable comments appear to have come entirely from auditors and issuers – those who stand to benefit from less rigorous independence rules. In contrast, the SEC rule changes met with strong objections from investor advocates,¹⁷ a former SEC Assistant Chief Accountant,¹⁸ and the SEC’s Democratic Commissioners.¹⁹ While the Board is not obligated to agree with those views, it does have a responsibility to carefully consider them and explain why it does not find them to be persuasive.

Unfortunately, the failure of the PCAOB to acknowledge, let alone address, the objections raised by these groups and individuals is consistent with its recent history of limiting investor input. Earlier this year, for example, in a meeting between investor groups and members of the PCAOB Board, Chairman Duhnke expressed surprise at the vehemence of the groups’ opposition to the Board’s recently adopted guidance on auditors’ communications with audit committees. We noted at the time that the Board might not have been taken by surprise had it conducted a notice and comment process before adopting the revisions to its guidance, and had it not chosen to dissolve other mechanisms for investor engagement, such as the Investor Advisory Committee. Since then, despite the Chairman’s speechmaking on the importance of transparency and engagement, nothing has been done to address those concerns, and the Chair and members of the Board are once again adopting policy changes with a direct impact on investors without any opportunity for investor input. The only reasonable conclusion is that the Board Chair and members are deliberately ignoring views of the very members of the public whose interests the Board is supposed to serve.

¹⁷ See, e.g., Letter from Council of Institutional Investors (Mar. 16, 2020), <https://www.sec.gov/comments/s7-26-19/s72619-6960357-212722.pdf>; Letter from Consumer Federation of America (May 4, 2020), <https://www.sec.gov/comments/s7-26-19/s72619-7146025-216304.pdf>; and Letter from Center for American Progress (May 26, 2020), <https://www.sec.gov/comments/s7-11-19/s71119-7228541-217032.pdf>.

¹⁸ Letter from Roy T. Van Brunt, Former Assistant Chief Accountant, Office of Chief Accountant, Securities and Exchange Commission (Jul. 23, 2020), <https://www.sec.gov/comments/s7-26-19/s72619.htm>.

¹⁹ Commissioner Allison Herren Lee and Commissioner Caroline A. Crenshaw, Who Watches the Watchers? Joint Statement on Auditor Independence Amendments (Oct. 16, 2010), <https://www.sec.gov/news/public-statement/lee-crenshaw-who-watches-watchers>.

As a result, out of basic respect for regulatory due process, the Commission should return the rules to the PCAOB with instructions to conduct a more thorough and inclusive process, including both a notice and comment rulemaking process and an economic analysis.

5) The basis on which the PCAOB justifies its action is invalid.

The PCAOB claims its rule changes are needed, and the rushed process is justified, to align the Board's rules with recent SEC rule changes. But those SEC rule changes were only published in the Federal Register on December 11 and do not take effect until 180 days after publication. Accordingly, they will not have reached their effective date by the start of the Biden Administration. The agency's new leaders will have plenty of time to begin rulemaking to withdraw or revise the rules. Given that the rules were adopted on a partisan vote, these rules are strong candidates for reversal, or at least extensive revision, in the new administration. Therefore, if the PCAOB's goal really is to align its rules with SEC rules, the only sensible approach is to withdraw the rule at least until the fate of the SEC rules is clear. This would have the added benefit of providing the PCAOB with plenty of time to conduct a proper rulemaking, with an opportunity for notice and comment by interested stakeholders.

* * *

There are good reasons to ensure that PCAOB and SEC rules regarding related issues do not conflict. But it doesn't automatically follow that PCAOB should simply pattern its rules on SEC rules, nor that it can act without conducting any separate inquiry and without considering how those rules may impact related PCAOB standards. Moreover, there is no need, and therefore no justification, for rushing this rule through the approval process. Even if the SEC rule is not subject to any added delay in the new Administration, it will not become effective before June at the earliest. That gives the Board plenty of time to conduct a full and open regulatory process and still coordinate implementation of its rules with implementation of the 2020 SEC rules changes, should they go into effect as scheduled. We therefore urge the Commission to deny the requested rule change while the fate of the related SEC rules remains in question and to direct the PCAOB to use the intervening time to conduct a more robust regulatory process.

Respectfully submitted,

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Alliance of Concerned Investors

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