McGladrey LLP

One South Wacker Drive, Suite 500
Chicago, IL 60606
www.mcgladrey.com

McGladrey

January 29, 2014

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

Re: PCAOB Rulemaking Docket Matter No. 029

McGladrey LLP appreciates the opportunity to offer our comments on Public Company Accounting Oversight Board (PCAOB) Release No. 2013-009, *Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor's Report of Certain Participants in the Audit*. McGladrey LLP is a registered public accounting firm serving middle-market issuers, brokers and dealers.

We support increased transparency related to the audit where such transparency improves audit quality or better enables financial statement users to make well-informed decisions about their investments or their voting decisions. In issuing the reproposal, the PCAOB stated it believed that "providing information about the engagement partner and the other participants in the audit in the auditor's report would be useful to investors and other financial statement users."[1] We question and have significant concerns about how the disclosure of the identity of the engagement partner without appropriate context will help investors make better informed decisions.

Even if one believes additional transparency about the identity of the engagement partner is potentially beneficial, a balance must be achieved when weighing the potential benefits of transparency with the impact of the associated costs and consequences for audit firms, audit partners, issuers, and the capital markets at large. We believe there are significant potential unintended consequences, liability implications, and practical challenges associated with providing disclosure in the auditor's report of the name of the engagement partner and disclosure of other accounting firms and other persons not employed by the auditor. The PCAOB's release does not present clear evidence that any incremental benefit of such information in the audit report outweighs the potential costs and consequences. As further explained in our comments below, should the PCAOB determine that disclosure is warranted, we believe there are more appropriate disclosure mechanisms that would provide financial statement users better information with fewer associated costs and consequences.

Reproposed Amendments to PCAOB Auditing Standards for Disclosure of the Engagement Partner

Unintended consequences of providing information without appropriate context

Including the engagement partner's name in the auditor's report does not provide the appropriate context around or insight into the partner's work experiences or skill level. This lack of disclosure of relevant facts could cause investors to draw inappropriate conclusions about an engagement partner's qualifications to serve as the engagement partner for an issuer especially if the engagement partner is the partner of record for a limited number of issuer audits. For example, if an engagement partner's name is disclosed

[1] PCAOB Release No. 2013-009, page 2.

in only one issuer audit report for a financial institution, the financial statement user could erroneously infer that the engagement partner has very limited experience in auditing financial institutions. What may be unknown to the investor is that the engagement partner has robust experience in auditing financial institutions, such as when that engagement partner also (a) is the engagement quality reviewer for other audits of issuer and non-issuer financial institutions, (b) is the engagement partner for audits of non-issuer financial institutions and/or (c) has extensive experience in the firm's national office as a consultant for matters related to audits of financial institutions. This example illustrates an unintended consequence of the reproposed requirement that may have a larger impact on firms (other than the very large U.S. registered public accounting firms) whose partners may serve primarily non-issuers but are equally qualified to lead audits of issuers.

Information about an engagement partner's work experiences and skill level typically is given to the client's audit committee. Such information often includes the engagement partner's requisite experience in auditing entities in specialized industries, *etc*. After reviewing this information, an audit committee reaches a decision on its satisfaction with the experience and expertise of both the audit firm and the engagement partner. Nevertheless, the very limited nature of the reproposed required public disclosure about the engagement partner could result in an audit committee, for fear of potentially adverse marketplace reactions, being reluctant to engage a new audit firm or accept the assignment of a proposed engagement partner if the partner has a limited prior record of serving as the lead audit engagement partner for an issuer even though the engagement partner may have extensive experience serving non-issuer audit clients in the issuer's industry. This is another illustration of an unintended consequence of the reproposed requirement that may have a larger impact on firms whose partners serve primarily non-issuers but are equally qualified to lead audits of issuers.

We also believe requiring the disclosure of the engagement partner's name in the auditor's report could result in users reaching erroneous, inappropriate, or uninformed conclusions about the engagement partner or the quality of the audit because of the proximity of other factors in the auditor's report. Certain circumstances about a company disclosed in the auditor's report are not within the control of the engagement partner and do not directly relate to the performance of that engagement partner or the quality of the audit (*e.g.*, bankruptcy, going concern uncertainty, or material weaknesses in internal control over financial reporting). We question how an investor might interpret a situation where, for example, an engagement partner is named in an audit opinion with an explanatory paragraph for a going concern uncertainty. Would investors interpret that as a negative indicator about the engagement partner because of his or her association with an issuer in this financial situation, or would they interpret it as a positive indicator about the engagement partner because, in exercising his or her professional judgment, the partner determined disclosure of a going concern uncertainty was appropriate in the circumstances?

The Release states, "Some commenters have suggested that over time with the reproposed disclosure requirements in place, a body of information about the engagement partner's history will be developed that, when connected with other data, would be useful to investors and other financial statement users."[2] We are concerned that the creation and use of "engagement partner scorecards" by investors and other stakeholders without the appropriate context and/or based on factors outside the control of the engagement partner would be misguided in their attempts to evaluate the performance of engagement partners. We also are concerned that information gathered over time may be inaccurate and may likely be one-sided with a focus on negative matters. For example, consider a situation where the current-year engagement partner is named in a report that includes an explanatory paragraph for a restatement of financial statements with which he or she was *not* associated, such as when the partner is rotating onto

[2] PCAOB Release No. 2013-009, page 11.

the engagement or when the prior-year financial statements were audited by a predecessor firm. How will this information be reflected in the public domain?

Finally, we question what the impact may be on a partner's career if he or she is named in a report that includes an explanatory paragraph for a restatement. Could this potentially impact the partner's career serving public companies because an audit committee may not want its company to be served by an engagement partner who is associated with a restatement? If so, this seems like a "one strike and you're out" approach that will discourage auditors from agreeing to initially serve or continue to serve as the partner on public company audit engagements.

Liability considerations

We respectfully disagree with the PCAOB's assertion that the benefits provided to investors and others through the identification of engagement partners and other participants in the audit report justifies the increased liability against such individuals, most notably liability as to claims under Section 11 of the Securities Act of 1933. Section 7 of the Securities Act requires issuers to file with the SEC the consent of any accountant who is named as having prepared or certified any part of a registration statement or any valuation or report included in the registration statement filed with the SEC. The PCAOB "has assumed that engagement partners and participating accounting firms named in an auditor's report would have to consent . . . . to the inclusion of their names in such an auditor's report filed with, or included by reference in, another document filed under the Securities Act with the Commission."[3] A very real consequence of providing such consents is that engagement partners (and others named in the audit report) will likely be subject to Section 11 liability.

Section 11 imposes liability for material misstatements or omissions in a registration statement, subject to a "due diligence" defense, on "every accountant . . . who has with his consent been named as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement . . . which purports to have been prepared or certified by him."[4] While the PCAOB has stated in its Release that, in proposing additional disclosure, it has sought to mitigate any potential increase in liability as to the engagement partner,[5] we do not believe it has effectively done so with respect to Section 11 liability.

Because such claims do not require proof of causation, reliance or intent, Section 11's reach is broad and severe with the potential for considerable damages being awarded based upon the difference between the offering price and value of the securities at the time of the lawsuit. And, while historically there may not be many Section 11 claims against accounting firms, we believe these types of claims are likely to increase where a registration statement has been filed given Section 11's low burden of proof and the increased difficulty in bringing Section 10(b) claims against accountants after the Supreme Court's decision in *Janus*.[6] Additionally, an engagement partner's consent may provide plaintiffs with an argument to circumvent *Janus* in Section 10(b) claims. By virtue of the engagement partner's consent, combined with the disclosure of the partner's name in the audit report, the plaintiffs may argue that the

[3] PCAOB Release No. 2013-009, pages 21-22.

[4] 15 U.S.C. § 77k.

[5] PCAOB Release No. 2013-009, page 20.

[6] *See Janus Capital Group, Inc. v. First Derivative Traders*, 131 S.Ct. 2296, 2302 (2011) (clarifying that, for claims brought under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, the "maker" of a statement is the "person or entity with ultimate authority over the statement, including its content and whether and how to communicate it").

partner is effectively a “maker” of an alleged misrepresentation contained in the audit report under *Janus*.[7]

The Board also does not appear to have adequately considered the legal implications under state law. Blue sky laws vary widely by state, in statute and interpretation. Unlike federal securities laws, an auditor may be secondarily liable for aiding and abetting under the application of certain states’ blue sky laws, and a number of states recognize causes of action by a holder of securities who claims to have relied on false statements. As with Section 11 claims, plaintiffs are more likely to rely on state law claims after *Janus*. The identification of the partner would increase the likelihood of the partner being named in a state law blue sky or common law claim.

As to all the potential claims against the engagement partner described above, we are concerned that the PCAOB understates the impact on litigation costs that will be incurred by the accounting firms as a result of the proposed disclosures. The addition of one or more individuals may significantly impact a firm’s defense costs in that it may not only require the use of separate counsel, but will also impact the facts and legal theories at issue, the defense strategy and the litigation dynamics. In summary, we have significant concerns that naming the engagement partner in the auditor’s report could increase the number of unwarranted claims brought against partners solely by providing that information to plaintiffs and plaintiffs’ counsel. As a result, the Board’s reproposal runs the unintended risk of increasing litigation costs and disrupting client services provided by engagement partners.

Finally, while not necessarily a liability consideration, we believe it bears mentioning that an increased risk of litigation may negatively affect an engagement partner’s behavior, such as by reducing his or her willingness to participate in audits of public companies. This effect may be more pronounced at firms that derive a larger percentage of revenue from private company audits (*i.e.*, some smaller firms) or smaller, regional offices of larger firms that have fewer partners available to serve on audits of public companies, which may impact their ability to compete for audits of public companies. Further, increased personal litigation against engagement partners will be a disincentive for firm professionals to remain in the public accounting profession.

Practical challenges in obtaining consents from the engagement partner

As stated above, the PCAOB “has assumed that engagement partners and participating accounting firms named in an auditor’s report would have to consent as well to the inclusion of their names in such an auditor’s report filed with, or included by reference in, another document filed under the Securities Act with the Commission.”[8] Obtaining consents from predecessor partners would cause duplicative efforts for firms, resulting in additional costs – both in terms of fees and timeliness of the filing of the registration statement. The fees for such compliance efforts to obtain consents may not be insignificant, especially to smaller reporting companies.

For example, if the lead engagement partner has rotated off the engagement and a registration statement is filed after the original date of the audit report but prior to issuance of the next year’s audit opinion, that partner would be required to provide a consent for the past engagement, even though he or she is no longer associated with the issuer, and would be subject to liability under Section 11 of the Securities Act. However, Section 11(b)(3)(B) states that the accountant will not be held liable if he can sustain a burden of proof that “he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material act required to be stated therein or necessary to make the

[7] *See id.*
[8] PCAOB Release No. 2013-009, pages 21-22.

statements therein not misleading." The exiting partner therefore will need to perform additional procedures, including reviewing the registration statement, before consenting to the inclusion of his or her name in the document. Current independence rules would appear to preclude the exiting partner from performing such additional procedures during the "time-out" period. Therefore, it appears the standard as reproposed would put an exiting partner in an unacceptable position where he or she either violates the standard of due care or the independence rules.

There also will be practical challenges in obtaining consents in certain circumstances, such as when a registration statement is being filed after the original date of the audit report and the lead engagement partner has left the audit firm prior to issuance of the next year's audit opinion. In such circumstances, at a minimum, there could be delays in obtaining a consent from a lead engagement partner who is no longer with the audit firm, and such delays would affect the timely filing of a registration statement. More importantly, we question the feasibility of requiring a former partner to sign a consent because there will be practical challenges with respect to providing indemnification, amending partnership agreements, *etc*. Additionally, in situations where consents are required from an engagement partner who is no longer associated with an audit firm, it is unclear whether such a partner would be allowed the ability to perform certain procedures, due to concerns about the sharing of confidential information. For example, this could happen when a former partner becomes a partner at a different audit firm or becomes the chief financial officer of a company that is a competitor of the issuer.

In addition, it could be possible that a retired partner would no longer have a license to practice and therefore would not be in a position to sign a consent. Further, the standard as reproposed appears to have no remedy for situations where a registration statement is being filed after the original date of the audit report and the lead engagement partner has been reclassified by the audit firm to a non-partner position; has been censured or restricted by the PCAOB or the SEC; has become medically incapacitated; or died prior to issuance of the next year's audit opinion.

Form 2

If, despite the significant issues discussed above, the PCAOB proceeds with the requirement to disclose the engagement partner's name, the PCAOB could add to Form 2 a requirement to disclose the name of the engagement partner for each audit required to be reported on the form, instead of in the auditor's report. Such disclosure would eliminate the liability concerns under Section 11 of the Securities Act and obviate any need for additional time and fees to obtain a consent from the engagement partner under Section 7. The disclosure of the engagement partner on Form 2 also would allow the information regarding an engagement partner to be easily accessible to financial statement users in one location. The housing of information by the PCAOB in one location on Form 2 also would help to ensure historical information is complete and can be compiled accurately by those who may desire to do so.

Because Form 2 currently is a static form that must be filed no later than June 30 of each year for the preceding 12-month period from April 1 to March 31, we recommend the PCAOB also consider alternatives that would provide financial statement users with the information in a more current timeframe. Such alternatives could include:

- Requiring specific Form 2 data to be filed on a periodic basis
- Creating a real-time web-based database that would be updated for changes in information within a stipulated number of days after the filing of the financial statements

Although audit firms will incur costs to develop processes to gather and maintain such information, we believe such costs will be significantly less than the overall costs of ongoing consent compliance efforts as currently proposed.

Reproposed Amendments to PCAOB Auditing Standards for Disclosure of Other Accounting Firms and Other Persons Not Employed by the Auditor

Providing financial statement users with useful information

In general, we believe the disclosure of the names of individual audit firms participating in the audit above the 5% threshold provides useful information to investors. However, we do not believe useful information is provided to investors by disclosing the number of other audit firms whose individual extent of participation in the audit engagement is less than 5% of the total audit hours. We believe the PCAOB should consider not requiring disclosure of the number of other audit firms whose individual extent of participation in the audit engagement is less than 5% of the total audit hours.

We also question the usefulness to an investor of the proposed required disclosure of the fact that a person not employed by the firm participated in the audit. In particular, the inclusion of specialists in this definition will lead to this disclosure in every audit engagement in which a firm engages a third-party valuation specialist or actuary, which is not all that uncommon - especially in certain industries. Also, because this disclosure is required of other persons *not* employed by the auditor, such disclosure may be a disadvantage for firms that consult a third-party actuary, valuation specialist, or other specialist while larger firms may employ professionals with these specialized skills. Therefore, we believe the PCAOB should reconsider inclusion of specialists in the disclosure requirements and should consider not requiring disclosure of the use of a person not employed by the firm if the extent of participation in the audit engagement by such a person is less than 5% of the total audit hours.

Practical challenges in obtaining consents from foreign firms

The reproposed requirement to disclose other accounting firms could slow the process of raising capital because audit firms who are individually named in the audit report will have to provide their consent pursuant to Section 7 of the Securities Act, as discussed above. Therefore, all audit firms identified within the audit report likely will need to review the registration statement and perform additional or updated procedures before providing a consent. Further, foreign firms may have challenges in reviewing a document that is not written in their native language. Conceivably, the logistical challenge of obtaining consents from foreign firms that are dated concurrent with the filing of the registration statement could be significant. Each of these factors could delay the process of filing a registration statement and will add additional cost.

Preferable alternative

We believe it would be preferable if the PCAOB would add a requirement to disclose other accounting firms for each audit required to be reported on Form 2, instead of in the auditor's report. This would make the information publicly available, but would obviate any need for additional time and fees to obtain consents from such firms under Section 7 of the Securities Act. The disclosure of other accounting firms on Form 2 also would allow the information to be easily accessible to financial statement users in one location.

Scope of Reproposed Amendments to PCAOB Auditing Standards

The PCAOB has stated it believes that "disclosure of the engagement partner and other participants in the audit would provide investors in U.S. companies with important information about the audits conducted for their benefit."[9] For a non-issuer broker-dealer, there are no investors. The ownership of brokers and dealers is primarily private, with individual owners generally being part of the management team. Disclosure of the engagement partner or other participants would be of no use to individual owners. Therefore, we believe the final standard should not be applicable to audits of non-issuer broker-dealers.

Likewise, we also do not believe the final standard should be applicable to audits of employee stock purchase, savings and similar plans that file annual reports on Form 11-K. Such a plan holds investments in its plan sponsor's own equity securities which generally are publicly traded, and the plan sponsor files annual audited financial statements with the SEC. We do not believe disclosure of the engagement partner or other participants in the audit would be meaningful information for participants in an employee benefit plan that is subject to PCAOB auditing standards.

We would be pleased to respond to any questions the Board or its staff may have about our comments. Please direct any questions to John Keyser, National Director of Assurance Services, at 614.456.2805 or Scott Pohlman, National Director of SEC Services, at 612.455.9499.

Sincerely,

McGladrey LLP

[9] PCAOB Release No. 2013-009, page 5.