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

**PCAOB Rulemaking Docket Matter No. 31**  
***Application of the “Failure to Supervise” Provision of the Sarbanes-Oxley Act of 2002 and Solicitation of Comment on Rulemaking Concepts***

Dear Mr. Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board’s (PCAOB or the Board) Release No. 2010-05, *Application of the “Failure to Supervise” Provision of the Sarbanes-Oxley Act of 2002 and Solicitation of Comment on Rulemaking Concepts* (Release). We generally support the Board’s proposed rulemaking principal objectives, as stated in the Release, to provide “clarity within firms about accountability for supervisory responsibilities and the creation of documentation identifying lines of accountability.” Further, we would support formulation of a rule that, only in general terms, requires assignment of responsibility, and documentation of that assignment, consistent with the provisions of the Board’s professional standards.

Effective supervision is fundamental to any system of audit quality control, and permeates all quality control elements designed and maintained collectively to provide reasonable assurance that a firm’s personnel are complying with applicable professional standards and regulatory and legal requirements, and with the firm’s standards of quality. The strength of a firm’s control environment is influenced by the extent to which individuals understand their responsibilities, recognize that they will be held accountable and understand the related implications of that accountability. We believe that documentation of a firm’s supervisory structure would enable a clearer understanding of responsibilities in the context of the respective system of audit quality control. That clearer understanding supports the effective operation of a system of audit quality control.

We note that the PCAOB’s Office of the Chief Auditor’s standard setting agenda (October 2010) includes a project entitled, “Quality Control Standards, Including SEC Practice Section Requirements.” We encourage the Board to move forward with the quality control standards project and consider, as a baseline, the quality control standards issued by the Auditing Standards Board of the AICPA and the International Auditing and Assurance Standards Board subsequent to the PCAOB’s 2003 adoption of interim standards. Due to the pervasive impact of supervision on any system of quality control, we believe that it is most appropriate for any documentation



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requirement relative to supervision assignments and responsibilities contemplated in the Release be considered in the context of the broader quality control standards project.

The remainder of this letter addresses those matters that may benefit from further consideration if the Board moves forward with rulemaking requiring firms to make and document clear assignments of responsibility for implementing their quality control policies and procedures.

*General Observations.* 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 a 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 requiring assignment of specific supervisory responsibilities to specific individuals.

To illustrate our concern, it is important to recognize that most accounting firms have a wide range of professionals whose responsibilities have some bearing on the functioning of the system of audit quality control and, accordingly, on audit quality. 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.



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- 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 a large number of 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 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. 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



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Section Manual § 1000.08(d), (f)<sup>1</sup>, (j), (m), (n)(1) and (o)), to the extent not superseded or amended by the Board. [emphasis added]

We believe that any requirement to make and document clear assignments of relevant supervision responsibilities embodied in a system of audit quality control must provide sufficient flexibility to permit practical implementation by registered firms of varying size and complexity. Accordingly, as noted above, we would support formulation of a rule that, in general terms, requires a process for assignment of responsibility, and documentation of such assignments, consistent with the provisions of the Board's professional standards. A more detailed rule that identifies and defines specific areas of supervisory responsibility, and requires firms to assign responsibility in each area, does not take account of the significant variability in firm organizational structures developed and implemented to support compliance with the provisions of the Board's quality control standards.

A more general formulation would require development of a clear objective of the related requirements. In addition, while clear and operational definitions of certain terms, including "supervisory responsibilities" and "supervisory personnel," likely would be necessary to ensure appropriate and consistent interpretation of the Board's requirements, any rule should provide sufficient flexibility enabling a firm to determine the assignment of supervisory functions within its system of audit quality control.

*Alignment with Quality Control Standards.* A system of quality control, designed and maintained pursuant to the Board's quality control standards, is broadly defined as "a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality."<sup>2</sup> The last sentence of the first paragraph on page 12 of the Release, stating 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," 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.

We believe that the message communicated in the last sentence of the first paragraph on page 12 of the Release is inconsistent with the objective of a system of quality control in the Board's quality control standards. Footnote 5 in QC Section 20 indicates that, "...deficiencies in individual...engagements do not, in and of themselves, indicate that the firm's system of quality

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<sup>1</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>2</sup> See QC Section 20, *System of Quality Control for a CPA Firm's Accounting and Audit Practice*, paragraph 20.03.



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control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards.” As previously noted, we believe that any supervisory responsibility documentation requirement proposed by the Board should be made part of the quality control standards and considered in the context of a firm’s system of audit quality control in its entirety. We acknowledge that rulemaking by the Board likely will be operationalized to complement application of section 105(c)(6). However, we believe that the objective of the Board’s proposed rulemaking should be stated in the context of the PCAOB’s quality control standards.

*Broker-Dealer Comparison.* The Concept Release suggests that the supervisory structure imposed on broker-dealers may present an appropriate model for supervision of public accounting firms. This comparison appears to rest on a line from the Senate Report<sup>3</sup> which suggests that “[t]he terms for liability for failure to supervise are similar to those that apply to broker-dealers under section 15(b)(4) of the Securities Exchange Act of 1934.” The Release, however, omits the remainder of the sentence linking this “similarity” to the provisions contained in the Safe Harbor Provision of section 105(c)(6)(B), not to section 105(c)(6)(A) providing the Board’s authority to impose liability for failure to supervise.

We believe that the broker-dealer model of supervision does not provide a useful guide for constructing rules for supervision of the auditing profession. The NASD rules under which broker-dealer supervision is maintained are highly detailed and prescriptive, intended to give definitive guidance in a business with a rigid hierarchical structure wholly unlike that of an accounting firm. These detailed requirements 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. While the SEC has brought charges in the broker-dealer arena challenging the actions and judgments of more senior officers and supervisors, those cases<sup>4</sup> are highly fact-specific and do not present practical direction in the context of accounting firm supervision. We also submit that the Board has the ability to bring charges of a similar nature under the authority of section 105(c)(6) as it stands.

*Part I Comments.* We acknowledge that the Board has not sought comment on Part I of the Release, describing it as “intended to highlight the scope of section 105(c)(6)’s application”. However, we believe that a number of matters addressed in Part I are relevant to any supervisory requirement mandated by the Board. These matters are addressed below.

- As noted above, we believe that appropriate and consistent interpretation of any Board rule likely will require clear and operational definitions of certain terms, including “supervisory

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<sup>3</sup> S. Rep. No. 205, 107<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (June 26, 2002), at 11.

<sup>4</sup> See, e.g., *In re Patricia A. Johnson*, 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); *In re Gutfreund*, SEC Release No. 34-31554 (Dec.3, 1992); *In re Urban*, Initial Decision Release No. 402, Admin. Proceeding File No. 3-13655 (Sept. 8, 2010).



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responsibilities” and “supervisory personnel.” These definitions should be developed for inclusion in the Board’s professional standards and interpreted consistently pursuant to the provisions of section 105(c)(6). To facilitate a common interpretation of supervisory responsibilities and supervisory personnel, we believe that further guidance regarding an individual’s responsibility, ability or authority in relation to the person or persons presumed to commit a predicate violation is essential.

- Consistent with our recommendation above to further develop definitions for supervisory responsibilities and supervisory personnel, we believe that the Board should consider developing guidance addressing the concept of nexus for purposes of interpreting the provisions of section 105(c)(6). 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.” Guidance addressing how the concept of “a sufficient connection” should be considered will assist firms when establishing clear lines of supervisory accountability and responsibility.
- Section 105(c)(6) provides that the Board may impose sanctions on a registered public accounting 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*, with a view to preventing violations of this Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission under this Act, or professional standards.” [emphasis added] According to the Release, “...the range of conduct that the Board might address through the ‘or otherwise’ clause encompasses conduct not covered by any supervision rules or standards. For conduct in this category, 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.” Accordingly, interpreting the phrase, “or otherwise,” as encompassing any possible failure to supervise effectively decouples liability from any rule or standard. This decoupling undermines a firm’s ability to make and document supervisory responsibilities consistent with the Board’s professional standards.
- The Release states that under the Board’s view of section 105(c)(6)(B), “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 [of subsection (B)] was not satisfied. Rather, a respondent who seeks to rely on section 105(c)(6)(B) would bear the burden of raising it and establishing that all three elements are satisfied.” In effect, the Board views subsection (A) as establishing the measure of the violation, and subsection (B) as an affirmative defense. The support cited by the Board for its assertion is a statement in the Senate Report that “the



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provisions of section 105(c)(6) permit an accounting firm to defend itself from supervisory liability by showing that its internal control procedures were reasonable and were operating fully in the situation at issue.”

We have several concerns about the Board’s assertion. First, as a “rule of construction,” one does not look to the legislative history for interpretative guidance unless the law is ambiguous on its face, which we submit it is not. Subsection (B) is captioned as the “Rule of Construction” applicable to section 105(c)(6). A rule of construction establishes how the terms of the law will be defined and how they will be applied in operation. There is nothing within subsection (B) that sets forth the “burden-shifting” approach that the Board ascribes to it; indeed, as a “rule of construction,” subsection (B) cannot be read to include a meaning not expressed within it.

Second, we do not read the Senate Report’s reference to indicate Congress’ view that a respondent must carry the affirmative burden of demonstrating that he or she should not be subject to liability. The Senate Report refers to the subsection as permitting “an accounting firm” to defend itself from supervisory liability, yet subsection (B) states that, “No *associated person* of a registered public accounting firm shall be deemed to have failed reasonably to supervise any other person” under this rule of construction. [emphasis added] In addition, there is a well-established presumption that conditions written into the statutory text should be considered elements of the offense, not affirmative defenses.

Finally, the aforementioned assertion by the Board conflicts with its statement that section 105(c)(6) “does not create a form of strict ‘failure to supervise’ liability.” The Board’s effort to shift the burden for the elements of subsection (B) to the respondent would do just that. That defenses may be available to avoid imposition of “strict liability” does not convert it to the “reasonable conduct” standard that the Board ascribes to section 105(c)(6) elsewhere in the Release. Accordingly, we recommend that the Board reconsider its assertion set forth in Part I of the Release.

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We appreciate the Board’s careful consideration of our comments. If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Craig Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

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cc: PCAOB Members and SEC Commissioners

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