Rulemaking Docket Matter No. 049

Proposed AS 1000 -- General Responsibilities of the Auditor in Conducting an Audit

Response to Request for Public Comment by Robert A. Conway, CPA

May 29, 2023

I have read the public comment letter on the PCAOB website submitted by the Members of the Investor Advisory Group applicable to the general responsibilities of the auditor. I agree with the feedback and suggestions included in that letter. I have four additional observations described below that merit the PCAOB's consideration:

1. **Contradictory Evidence** -- The PCAOB standards have important reminders about the auditor's duty to consider contradictory evidence. However, I do not believe the auditing literature is sufficiently clear about the auditor's duty to conduct a reasonable search for contradictory evidence. Greater clarity as to the auditor's duty to identify contradictory evidence is important in light of the profession's ongoing struggle to demonstrate an appropriate level of professional skepticism. The IAG letter makes some related observations about the presumption that management is dishonest rather than assuming management is neither honest or dishonest. My suggestion takes this a little further by obligating the auditor to search for contradictory evidence.

   The exhibit to this letter contains excerpts from the auditing standards that I considered while vetting this recommendation. Paragraph 11 of AS 2110 has "should consider" language. Here are some basic things I believe need to be in the "should" or "must do" category:

   a. Conduct a series of internet searches using the company name, the names of major products, and the names of officers. The absence of such a requirement in the existing standards is an example of the existing standards being out of date;
   b. Listening to the earnings calls should be mandatory; and
   c. Understanding the content of all public filings, including all 8-Ks, should be mandatory.

2. **Ethics and Integrity** - Below is an excerpt from my January 2020 public comment on possible revisions to the Quality Control standard. I repeated a similar comment in my public comment on the draft of the Quality Control standard in January 2023. This comment continues to be in need of attention by the PCAOB:

   22. **PCAOB Question**: Is the approach to relevant ethical requirements appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?

Conway Public Comment Response

The AICPA's Integrity and Objectivity standards have always forbidden the subordination of judgment when differing views arise over a material issue. In other words, a subordinate with a differing view is obligated to speak up on material matters. This construct is critical to audit quality. The AICPA, recognizing that it is not easy for subordinates to challenge overbearing supervisors, added provisions (circa 2014) prohibiting supervisors (including audit partners) from exercising undue influence over subordinates. In other words, a partner should not apply undue influence to override a subordinate and bypass appropriate dispute resolution protocols. These enhancements to the AICPA standards were made by the AICPA after the PCAOB adopted the AICPA standards in 2003. **It is important that the PCAOB at least catch up to the AICPA in this regard so that subordinates know that their PCAOB professional standards fully support their responsibility to voice their concerns, even in the face of an over-bearing supervisor.**

3. **Professional Judgment** – The proposed draft of AS 1000 has one paragraph devoted to professional judgment that reads as follows:

PROFESSIONAL JUDGMENT

.12 The auditor must exercise professional judgment, which involves applying relevant training, knowledge, and experience to make informed decisions and reach well-reasoned conclusions about the courses of action that are appropriate in the circumstances such that the audit is planned and performed, and the report or reports are issued, in accordance with applicable professional and legal requirements.[21]

[21] References to judgment of the auditor in other PCAOB standards have the same meaning as "professional judgment." *See, e.g.*, AS 1215.07*,* and paragraph .02 of AS 1220*, Engagement Quality Review*.

Poor professional judgment is intertwined with the lack of professional skepticism and independence and is frequently a root cause of audit failures. One would expect greater emphasis and definition of professional judgment than what we see above. Some have said it is not necessary for the PCAOB to publish a "professional judgment framework" because each of the audit firms have already published their own frameworks. Wouldn't the PCAOB have greater leverage from an inspection and enforcement perspective if there was a "PCAOB Framework on Professional Judgment"? Might the PCAOB be able to drive more improvements in audit quality if public company auditors were held to a suitably high standard for professional judgment? Yes, the auditing literature talks about considering contradictory evidence – but that is only a small part of the professional judgment frameworks developed by the largest audit firms. There is an abundance of good material about "professional judgment frameworks" in the public domain. It would not take much effort for the PCAOB to develop its own professional judgement framework for incorporation into the auditing standards.

4. **Time Pressures and the Archiving Date –** Public company auditors are typically under great pressure to "sign-off" on earnings at an earnings release date which in many cases precedes the filing of the annual report on Form 10-K by a significant period of time. **The unwritten expectation is that the results will not change during the period between the earnings release date and the public filing of the 10-K. This is an unhealthy dynamic and needs to change**.

   As part of the audit planning process, it is understandable that the auditor may have discussions with the issuer about when the issuer hopes to make an earnings release and the date the issuer hopes to file its 10-K. The "General Responsibilities of the Auditor in Conducting an Audit" should be clear that the auditor shall not make any firm commitment or make any promise as to when the audit will be completed. AS 1000 should remind the auditor that the date the audit opinion is signed and provided to the issuer shall be at the auditors' sole discretion and judgment. If the audit engagement partner believes that additional time may be needed to complete the audit, the engagement partner should confer with the Engagement Quality Reviewer and the Audit Committee. Any effort by the issuer or the audit committee to apply pressure with respect to the completion of the audit should be evaluated to determine if the issuer or the audit committee has violated Section 303 or the Sarbanes-Oxley Act regarding "Improper Influence on Conduct of Audits."

   The auditor should be expected to have periodic discussions with the audit committee about the progress of the audit. The audit committee should periodically inquire about the progress of the audit and the issuer's responsiveness to the auditors' information requests. The audit committee should also specifically ask if the auditor needs or may need additional time to complete the audit.

   The threat of time pressure to audit quality should also be addressed in any Professional Judgement Framework the PCAOB may develop in response to my comment # 3 above.

I hope the PCAOB finds my suggestions helpful. Please feel free to reach out to me if the PCAOB or its professional staff have any questions about my recommendations.

Sincerely,

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About Robert Conway -- My 360° Perspective on the Auditing Profession

I am a retired KPMG audit partner. I worked at KPMG for 26+ years, including 17 years as an audit partner. After retiring from KPMG, I joined the PCAOB where I worked from 2005 to

2014. During my last six years at the PCAOB, I was the Regional Associate Director with leadership responsibility for the PCAOB's Orange County and Los Angeles offices. Like virtually everyone else that joins the PCAOB, I was inspired by the PCAOB's important Mission to improve audit quality.

After leaving the PCAOB, I became the Professional Practice Director at CNM LLP, an 85-person regional CPA firm in Southern California that focuses exclusively on technical accounting consultations and SOX 404 outsourcing. My responsibilities put me in regular contact with Big Four audit partners, public company CFO's, Chief Accounting Officers, audit committees, and SOX Compliance Leaders. I worked at CNM for three years.

In 2019, I began serving as an expert witness in matters involving accounting, auditing, and internal controls over financial reporting.

In 2020, I published a book titled, "The Truth About Public Accounting – Understanding and Managing the Risks the Auditors Bring to the Audit."

My recommendation in 2007 to the US Treasury Department's Advisory Committee on the Auditing Profession (ACAP) was widely credited with providing the impetus for ACAP's final report recommendation that the PCAOB evaluate the feasibility and potential benefits of providing public transparency to audit firm input and output measures that may be indicators of audit quality (AQIs). The PCAOB ultimately published a Concept Release on Audit Quality Indicators in June 2015. A project to study "Engagement Performance Metrics" was added to the PCAOB's Research Agenda in 2022. That project recently moved to the PCAOB's Standard Setting Agenda.

Exhibit

Existing Standards Considered in Developing

My First Recommendation re Contradictory Evidence

AS 1105: Audit Evidence

Introduction

.01 This standard explains what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.

.02 Audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and information that contradicts such assertions.

PCAOB Release No. 2023-001, pages A1-4 to A1-5

.11 The auditor’s exercise of professional skepticism includes:

a. Objective evaluation of evidence obtained in an audit (including information that supports and corroborates management’s assertions regarding the financial statements or internal control over financial reporting and information that contradicts such assertions), and consideration of the sufficiency and the appropriateness (i.e., relevance and reliability) of that evidence;

b. Remaining alert to conditions that may indicate possible misstatement due to error or fraud;

c. Not relying on evidence that is less than persuasive;

d. Not assuming that management is honest or dishonest; and

e. Consideration of potential bias on the part of management and the auditor.

AS 2101: Audit Planning

Planning Activities

.07 The nature and extent of planning activities that are necessary depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit. When developing the audit strategy and audit plan, as discussed in paragraphs .08-.10, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality,[5] risk, and, in integrated audits, other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee[6] or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and
- The relative complexity of the company's operations.

  Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

AS 2110: Identifying and Assessing Risks of Material Misstatement

Obtaining an Understanding of the Company and Its Environment

.07 The auditor should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. Obtaining an understanding of the company includes understanding:

a. Relevant industry, regulatory, and other external factors;

b. The nature of the company;

c. The company's selection and application of accounting principles, including related disclosures;

d. The **company's objectives and strategies** and those related **business risks** that might reasonably be expected to result in risks of material misstatement; and

e. The company's measurement and analysis of its financial performance.

.08 In obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.

Industry, Regulatory, and Other External Factors

.09 Obtaining an understanding of relevant industry, regulatory, and other external factors encompasses industry factors, including the competitive environment and technological developments; the regulatory environment, including the applicable financial reporting framework[6] and the legal and political environment;[7] and external factors, including general economic conditions.

Nature of the Company

.10 Obtaining an understanding of the nature of the company includes understanding:

- The company's organizational structure and management personnel;
- The sources of funding of the company's operations and investment activities, including the company's capital structure, noncapital funding (*e.g.*, subordinated debt or dependencies on supplier financing), and other debt instruments;
- The company's significant investments, including equity method investments, joint ventures, and variable interest entities;
- The company's operating characteristics, including its size and complexity;

Note: The size and complexity of a company might affect the risks of misstatement and how the company addresses those risks.

- The sources of the company's earnings, including the relative profitability of key products and services; and

- Key supplier and customer relationships.

.10A To assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's financial relationships and transactions with its **executive officers** (*e.g.*, executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the Securities and Exchange Commission and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.

.11 As part of obtaining an understanding of the company as required by paragraph .07, the auditor should consider performing the following procedures and the extent to which the procedures should be performed:

- Reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and, in an integrated audit, the effectiveness of the company's internal control over financial reporting, *e.g.*, company-issued press releases, company-prepared presentation materials for analysts or investor groups, and analyst reports;

- Observing or reading transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies;

- Obtaining an understanding of compensation arrangements with senior management other than executive officers referred to in paragraph .10A, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses;

- Obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders to identify potentially significant unusual developments (*e.g.*, from Forms 3, 4, 5, 13D, and 13G);

- Inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and

- Obtaining an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.