August 10, 2023

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

Submitted via email to comments@pcaobus.org

Re: PCAOB Release No. 2023-003: Proposed Amendments to PCAOB Auditing Standards related to a Company’s Noncompliance with Laws and Regulations and Other Related Amendments

PCAOB Rulemaking Docket Matter No. 051

Dear Board Members:

The Society for Corporate Governance (“the Society”) submits this letter to express its views about the PCAOB’s proposed amendments set forth in Release No. 2023-003 (the “Proposal”).

Founded in 1946, the Society is a professional membership association of more than 3,700 corporate and assistant secretaries, in-house counsel, outside counsel, and other governance professionals who serve approximately 1,600 entities, including 1,000 public companies of almost every size and industry. Society members are responsible for supporting the work of corporate boards of directors and the executive managements of their companies on corporate governance and disclosure matters.

I. Overview

On June 6, 2023, the PCAOB proposed a new auditing standard for public comment: A Company’s Noncompliance with Laws and Regulations (“NOCLAR”), PCAOB Release 2023-003. The Proposal would replace existing Auditing Standard (“AS”) 2405, Illegal Acts by Clients, with a new AS 2405 that would significantly change the current standard and fundamentally alter the role of the auditor in ways that would encroach unnecessarily on, and create potential conflicts with, an audit client’s compliance and legal functions, the duties of its board of directors, and its attorney-client privilege with external and in-house counsel. Moreover, the Proposal would greatly increase the cost and complexity of financial statement audits without discernable benefit for the investing public.

For these reasons and others explained below, the Society recommends that the PCAOB withdraw the Proposal. The Society also notes that public companies have been provided inadequate time to comment, particularly in light of the extraordinary potential impact of the Proposal and the timing
of the comment period close to the end of the June 30 fiscal quarter, when companies prepare earnings releases and periodic reports for filing with the Securities and Exchange Commission (“SEC”). If the Board decides nevertheless to proceed with a revised proposal on NOCLAR, the Society calls on the PCAOB to first lay the proper groundwork, including by engaging in a meaningful dialogue with and obtaining input from key stakeholders, such as public companies, their auditors, and outside counsel before moving forward, and to undertake a rigorous cost-benefit analysis of any proposal that would depart from current standards and practices.

Below are our principal comments for consideration on select aspects of the Proposal.

II. Principal Comments

1. The Proposal would expand and transform the financial statement audit into a compliance audit that is unnecessary and would encroach on the domain, expertise, and discretion of public companies’ management-led compliance and legal functions.

Under the Proposal, the auditor would be required to plan and perform procedures to “identify the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements” and “identify whether there are instances of noncompliance with laws and regulations that have or may have occurred” (emphasis added).1 These steps far exceed the scope and expertise of an auditor’s role,2 and would encroach on the role and responsibility of a company’s compliance and legal functions, as well as the fiduciary duty of its board of directors to oversee its affairs and monitor its material risks.

The role of management vs. the role of auditors

Currently, PCAOB standards distinguish between the principal roles of management (prepares financial statements and establishes internal controls) and auditors (obtains reasonable assurance that financial statements are free of material misstatement, whether caused by error or fraud).3 As discussed below, the Proposal seeks a fundamental transformation of the auditor’s role without any meaningful explanation of why the current roles and allocation of responsibility between the external auditor, company management, and the board are inadequate, and without any data or quantification of the substantial costs the Proposal will entail.

Compliance and legal departments

Compliance and legal departments are a core function of public companies – they oversee legal compliance with applicable laws and regulations enacted by federal, state, county, city, and foreign governments. Compliance and legal personnel of public companies are charged with the important tasks of, among other things, identifying laws and regulations applicable to their companies; assessing compliance risk arising from their business operations and implementing measures to mitigate such risks; identifying the nature and extent of any compliance violations using

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1 Proposed AS 2405.04.
2 See AS 1001.01, .03 and .04, available here.
specialized knowledge, legal expertise and experience; and reporting significant concerns to senior management, the audit committee, and/or governmental authorities where appropriate.

The bedrock of a public company’s compliance program is its Code of Ethics, required by the Sarbanes Oxley Act of 2002 (“SOX”), and all other company policies that are implemented to help ensure compliance with applicable law. Moreover, in order to promote compliance with applicable law and heed guidance issued by the SEC, the U.S. Department of Justice (“DOJ”), and other agencies, companies must adopt and maintain risk-based compliance programs and related controls to prevent and detect non-compliant conduct, such as corrupt conduct prohibited by the U.S. Foreign Corrupt Practices Act (“FCPA”). Companies maintain and engage teams of lawyers and compliance professionals trained and devoted to this singular purpose. This comprehensive framework and the related processes that companies establish are augmented by whistleblower programs that alert management and, depending on the nature of the matter, the board, to issues of potential noncompliance.

Closely related to and part of a public company’s compliance program is the fiduciary duty of its board of directors to oversee its business and affairs by ensuring that systems and controls are in place to keep directors informed of developments related to key legal and compliance risks the company faces in its evolving business and regulatory environment. This risk-based approach to governance focuses corporate attention and resources on the risks that are most likely to occur with material impact to the company. To ensure a proper focus of the board on such material risks, companies establish and implement risk-based compliance programs and identify those significant matters that are escalated to the board for consideration.

**Proposal’s impact on existing governance structures**

The Proposal threatens to dilute, distract, and undermine both the board’s and management’s long-established risk-based processes by effectively requiring public company auditors to conduct a survey of all potentially applicable laws and determine whether the violation of any of them could reasonably have a material effect on the financial statements, regardless of the client company’s judgment about the actual risk of noncompliance. The Proposal applies to all laws and regulations (globally) irrespective of whether the laws and regulations involve financial or operational issues or unintentional versus intentional conduct. As a result, the Proposal would significantly expand the role of the auditor into an operational oversight role that is far beyond conducting a financial statement audit.

Moreover, the Proposal’s requirement that auditors identify all laws that, if violated, “could reasonably” have a material effect on financial statements (regardless of the likelihood of an actual violation) is overly broad and vague; conflicts with core auditing standards because, among other

4 See, e.g., the U.S. Department of Justice, Criminal Division, Evaluation of Corporate Compliance Programs (Updated March 2023), available here. See also White & Case LLP’s and KPMG’s 2023 Global Compliance Risk Benchmarking Survey, available here.
5 See In Re Boeing Decision Underscores Need for Risk-Based Corporate Governance by Directors, available here.
6 See AS 1001.04: “The professional qualifications required of the independent auditor are those of a person with the education and experience to practice as such. They do not include those of a person trained for or qualified to engage in another profession or occupation. For example, the independent auditor, in observing the taking of a physical inventory, does not purport to act as an appraiser, a valuer, or an expert in materials. Similarly, although the
items, it would require the auditor to make myriad legal judgments to be in a position to attempt to make this determination; and undermines the risk-based compliance programs that have long been established by public companies.  

2. Auditors are ill-equipped to assess the applicability of laws and regulations and whether they could reasonably have a material effect on a company’s financial statements, which is a highly complex process that will depend on the expertise of attorneys, their legal analyses, and on courts of law. Requiring auditors to take on this responsibility and role would cause unnecessary burdens on both auditors and their public company clients.

Identifying and assessing the nature and extent of possible violations of applicable laws and regulations requires the exercise of specialized knowledge and judgment that corporate legal and compliance personnel have and auditors do not. Requiring auditors to identify all applicable laws and regulations that could reasonably have a material effect on a company’s financial statements and to assess the existence and extent of possible violations duplicates, and risks materially conflicting with, the role and judgment of the company’s in-house and outside compliance counsel. As described further below, these risks are exacerbated when one considers the increasingly dense and complex array of laws and regulations to which the operations of modern corporations are potentially subject, now and in the future.

Nascent and rapidly evolving laws

Many areas of law are nascent and rapidly evolving, making it particularly challenging and costly even for seasoned legal and compliance professionals, let alone auditors, to identify applicable laws and regulations and test effectively for noncompliance.

Take for example laws related to privacy and data protection. By some estimates, 162 countries had enacted data privacy laws as of May 2023, 17 of which were enacted between 2021 and 2023. In the U.S., at least six new privacy laws were adopted at the state level between January to June 2023 alone. Although many of these laws share similar characteristics with the European Union’s General Data Protection Regulation (“GDPR”), they differ significantly in their application and specific requirements.

Currently, there are at least 11 U.S. states with comprehensive data privacy laws, and several other U.S. states that have proposed comprehensive data privacy laws. The protections afforded by state data privacy statutes often differ considerably from one state to another. Some of these statutes are comprehensive, while others cover areas as diverse as protecting library records to keeping homeowners free from drone surveillance. Even countries without comprehensive data privacy laws have significant sectoral privacy laws that protect certain personal data (for example, independent auditor is informed in a general manner about matters of commercial law, he does not purport to act in the capacity of a lawyer and may appropriately rely upon the advice of attorneys in all matters of law.”

7 See Footnote 3.
children’s personal data, financial data or health data).\(^9\) Depending on the data practices of the public company being audited, auditors may need to track all of these sectoral laws and identify which could materially impact the company.

As AS 2405 currently recognizes, assessing whether there is noncompliance “is a determination that is normally beyond the auditor’s professional competence” (emphasis added). The operational aspects of legal compliance often require subject matter expertise that is outside of an auditor’s range of expertise. Accordingly, auditors would not be able to satisfy the standards in the Proposal without significant assistance and involvement from lawyers and other subject matter experts, which unquestionably will increase the duration and cost of audits.

**Laws and regulations are inherently complex**

In addition to their evolving nature, the laws and regulations that are applicable to public companies often involve ambiguous and complex requirements, and lawyers are tasked with interpreting and assessing a company’s compliance and associated risk. Many evolving areas of law also contain requirements that hinge on regulators’ subjective interpretations of the law. For example, under regulations in the United Kingdom and California for protecting children online, businesses are instructed to make the “best interests of the child” a primary consideration when designing and developing their products and services. Sources of guidance on how best to achieve this subjective outcome are as numerous as they are evolving.\(^10\)

Moreover, court decisions interpreting the same law can be at odds with one another due to, for example, inconsistencies between or among the decisions of federal circuit courts of appeal or federal district courts and/or similar levels of state courts. These types of uncertainties, which are inherent in the legal arena, raise questions as to which standards a company must follow to be in compliance with an applicable law or regulation.

Similarly, the U.S. sanctions regime encompasses 46 distinct sanctions programs, administered by the U.S. Office of Foreign Assets Control (“OFAC”), each with its own unique prohibitions, interpretations, and requirements. Companies subject to U.S. sanctions jurisdiction must comply with these regulations, as well as a complex web of other economic sanctions statutes, executive orders, directives, determinations, general licenses, and their terms and conditions and recordkeeping requirements. To interpret these measures, companies must rely on a very limited set of court rulings and guidance from OFAC, making compliance in this area an especially challenging and ever-expanding endeavor.

**Public company operations implicate a wide expanse of laws**

Public companies often have wide-ranging operations that implicate a variety of laws and regulations around the world. Similarly, companies that operate in highly regulated industries or those with multinational operations face a wide array of applicable laws and regulations.

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\(^10\) See, for example, UK Information Commissioner’s Office, Best Interests of the Child Self-Assessment, available here.
Accordingly, the breadth and depth of the compliance function at public companies, particularly those in regulated industries, is often vast. The burden that this Proposal would place on auditors to identify applicable laws and regulations for a particular public company across multiple jurisdictions and legal subject areas, and assess compliance therewith, is correspondingly immense.

For example, a Society member at a large public company in the financial industry estimated that it is subject to more than 30,000 laws and regulations worldwide. Accordingly, only with tremendous help from professional legal and compliance resources could auditors even attempt to fulfill the Proposal’s mandate to understand all the laws and regulations around the globe to which each company is subject, including all local, state, federal, and foreign laws and regulations.

**Auditors are not equipped to assume the legal and compliance functions of their audit clients**

Likewise, to assess potential noncompliance, auditors would need to consider complicated legal questions and the application of potentially complex legal standards to particular facts to determine which laws apply in which circumstances, and whether they have been potentially violated – determinations that auditors are simply not in a position to make.

Complicated legal questions are matters for attorneys, and ultimately courts of law, to resolve, and there will be no value in the context of a financial statement audit for an auditor to identify the potential for contrary legal outcomes or positions from those taken by their own audit clients. Moreover, any disputes over legal interpretations, which are already inherent in the legal system, could create tension and undermine the relationship between auditors and their audit clients over legal complexities and uncertainties that are unrelated to a financial statement audit.

If adopted, the Proposal would require auditors to maintain not only knowledge of existing and newly adopted laws and regulations for each audit client, but also knowledge of how such legal standards are being applied in practice by attorneys and courts of law. As a result, false alarms of potential noncompliance could become increasingly common, as well as requests in litigation discovery and regulatory inquiries for audit work papers that contain legal assessments. This, in turn, could result in waivers of the attorney client privilege and additional burdens on audit committee members.

Oversight of compliance is not equivalent to numbers in a financial statement or the internal controls necessary to produce reliable financial statements. For example, with respect to Occupational Safety and Health Administration (“OSHA”) regulations on employee safety, the testing for compliance could require an auditor to monitor company personnel at employee sites for OSHA violations. Auditors are unlikely to be equipped to understand and make these compliance assessments, which are already addressed and subject to a company’s own policies and procedures.

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11 Emails from Society members who provided details on compliance obligations for inclusion in this letter are on file with author.
12 See Subsection 3 below, on page 7 of this letter.
For the reasons described above, requiring auditors to audit each audit client’s compliance and controls for the vast array of laws and regulations to which companies are subject as part of their audit is impractical, unworkable, and unduly burdensome.

3. The Proposal would create unnecessary delays and increase costs to complete the audits of a public company’s financial statements, which would ultimately harm investors and the public markets.

To complete a public company audit, independent auditors must, among other steps, audit and issue an opinion on the financial statements, test a public company’s internal controls, and request and rely upon management representation letters. The management of a public company, however, is ultimately responsible for preparing and ensuring the accuracy of the financial statements – not the independent auditors.\(^\text{13}\)

The process of completing an audit is time consuming, costly, and work intensive for both auditors and management. Each year, public companies implement comprehensive internal audit processes to support completion of their external audits on time and file their annual reports with the SEC by the applicable deadline. Auditors, in turn, face staffing and increasing cost challenges. The Proposal would add substantial and unnecessary costs and burdens for public companies and their auditors to complete a significantly expanded audit scope. The Proposal would significantly increase audit fees without any demonstrable benefit gained from the proposed expansion of auditors’ responsibility to proactively examine and test the universe of possible legal and regulatory noncompliance.

Indeed, the Proposal itself recognizes that imposing these new requirements would result in “additional, potentially substantial costs for auditors and the companies they audit,” but fails to quantify “substantial” or to estimate the expected costs of implementing the Proposal. Audit fees have been steadily increasing and have more than tripled from 2003 levels,\(^\text{14}\) and the Proposal would only accelerate this trend. Audit fees for public companies more than doubled between 2002 and 2004 during the implementation of SOX Section 404\(^\text{15}\) and the costs of the Proposal are likely to far exceed the costs of implementing Section 404 based on estimates from Society members.

This increase in audit costs would be passed on to public companies and ultimately to investors, who would bear the burden of decreasing shareholder value. While all can agree that noncompliance with laws and regulations could potentially have a material effect on financial statements, the Proposal and its corresponding increases in audit costs and burdens have not been shown to be necessary in light of management’s existing, well-established role in overseeing compliance and the general effectiveness of existing audit standards, as further described below.\(^\text{16}\)

Additionally, the internal processes that public companies would be required to establish as a result of the Proposal to address auditor concerns raised in the midst of an audit could be extensive and interfere with management’s role to oversee compliance, as well as the audit procedures conducted

\(^{13}\) See AS 1001.04.
\(^{15}\) See Twenty-Year Review of Audit & Non-Audit Fee Trends (October 2022) by Audit Analytics, available here.
\(^{16}\) See Subsection 4 below, on page 9 of this letter.
by public companies’ financial reporting teams. Effectively, auditors would be replicating the efforts (though almost certainly at a much shallower depth) of the audit client in identifying compliance issues, gathering evidence, conducting legal research, and/or interviewing employees. Conducting such parallel investigative activities would go beyond the ken of an appropriate audit function, without providing value, while increasing the costs and burdens for public companies and their auditors.

The “cost” of this time spent on compliance by auditors, including the additional burden on the audit committee and others involved, cannot be overstated. The volume of reporting to the audit committee required under the Proposal would lead to a substantial uptick in touchpoints between the auditor, management, and audit committee, each of which would bear a cost in terms of their time and attention. The Proposal could exponentially increase the amount of immaterial information being communicated to audit committees and could therefore distract audit committees and others from focusing on the key risks identified by the company’s own risk management and compliance procedures. By overloading audit committees with immaterial information and false “noncompliance” alarms, the Proposal would potentially reduce the effectiveness of audit committees and hamper their oversight responsibilities.

**Input from Society members on effect of Proposal**

In response to the Proposal, the Society invited input from member companies to understand the estimated effect of the proposed new audit standard on their current practices and costs. While the information provided is based on initial estimates and necessarily limited in view of the brief comment period and the novel and significant shift in auditor responsibilities, they are illustrative and support an expected sharp rise in costs and resource demands that would exceed any anticipated benefits.  

For example, one public company in the energy industry explained that if it were required to conduct and fully document compliance with each applicable law for purposes of a financial statement audit, it anticipates the incremental costs associated with just one of the many laws to which it is subject could amount to more than $750,000 each year. These additional costs, all of which are unnecessary in view of the company’s actual risk assessment and profile, would be multiplied by the wide range of other laws and regulations to which the company is subject, and require augmenting the size and budget of the company’s legal and internal audit teams. These steps would be necessary – not because of the likelihood of a violation – but because of the theoretical effect a potential violation could have on the company’s financial statements. Likewise, a company with more than $200 billion in market cap stated that the implementation of the Proposal would cause a level of effort well in excess of its costs for the implementation of SOX Section 404.

Moreover, a public company with a market cap of $1.7 billion emphasized that the costs and resource demands of the Proposal would disproportionately impact smaller companies. The company noted that while Section 404 controls and related costs can be scaled to some degree based on company size, the Proposal and associated costs would not be scaled, and thereby disproportionately impact small and mid-cap issuers. For example, a small or mid-cap oil and gas

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17 Emails from Society members who provided estimates for inclusion in this letter are on file with author.
company would be subject to the same legal framework, obligations, and requirements as a large-cap company in the same industry, as the same industry-based regulations would be applicable.

The ultimate result of these increased audit costs would likely be a continued decrease in the number of public companies and decline in the public markets. The number of public companies has already decreased by more than 50% since 1996,\(^{18}\) and the cumulative effect of the Proposal would be to accelerate this decline, as companies would increasingly be unable to afford the higher costs of being a public company.

In addition to these increased costs, it is unclear if companies would be able to find and hire additional audit personnel to meet these additional demands. A recent *Wall Street Journal* article cited a significant shortage of qualified accounting staff as the cause of numerous material weaknesses in companies’ internal controls over financial reporting. From January through June 2023, nearly 600 U.S.-listed companies reported at least one material weakness related to personnel issues, typically in accounting or information technology, up 40.6% from the same period in 2019.\(^ {19}\)

The PCAOB’s failure to quantify the admittedly substantial costs that adoption of the Proposal would entail for public companies and auditors or to offer a rigorous analysis of why this fundamental change in the auditor’s role is necessary underscores why adoption of the Proposal is premature and unwarranted.

4. The Proposal fails to adequately explain why the existing framework and standards are inadequate or the legal basis for the PCAOB’s authority to expand the auditor’s role in this manner.

In the experience of the Society and our public company members, the current structure and framework for assessing illegal acts works effectively in practice, and there is no legal basis for the PCAOB to so fundamentally disrupt the current structure and framework established by SOX.

Section 10A of the Securities Exchange Act of 1934 already requires auditors to design and perform procedures to provide reasonable assurance illegal acts will be detected that would have a *direct and material effect* on the determination of financial statement amounts. In line with this requirement, under the existing audit framework,\(^{20}\) auditors consider any laws that have a direct effect on the financial statements in the process of planning, assessing risk, and performing field work, such as tax laws that materially impact the manner in which taxes are presented in the financial statements.

With respect to laws that only *indirectly* affect financial statements, the existing framework also provides for robust procedures. In particular, Accounting Standards Codification (“ASC”) 450 already provides a framework for assessing the impact of noncompliance on financial statements, by specifically requiring public companies to recognize or disclose a loss from noncompliance in circumstances when it is probable that a liability has been incurred or when a loss is reasonably

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\(^{20}\) AS 2405, *Illegal Acts by Clients*. 
possible. Considering these thresholds built into ASC 450, including the need for there to be at least a reasonable possibility of a loss, the existing standards under AS 2405 reflect a well-calibrated and proportional approach that incorporates concepts of materiality.

Moreover, the existing audit standards rely on legal subject matter experts and include a variety of audit procedures, such as reviewing board meeting minutes, making inquiries of management and legal counsel relating to litigation, claims and assessments, and making inquiries of the audit committee. In addition, the management representation letters specifically required by AS 2805 must address any violations or possible violations of laws or regulations whose effects are considered for disclosure in the financial statements or as a basis for recording a loss contingency.

SEC rules also impose requirements that bolster auditing standards relating to noncompliance, including: (i) the quarterly SOX certifications filed with the SEC and signed by chief executive and chief financial officers certifying that they have disclosed to the auditors and to the audit committee any fraud, whether or not material, involving employees with a significant role in internal control over financial reporting; and (ii) whistleblower procedures required to provide employees with an avenue to confidentially and anonymously submit concerns to a company regarding questionable accounting or auditing matters.21

For an audit client, these management representation letters, certifications, and whistleblower procedures, as well as the letters provided by outside counsel to support management representations, involve extensive and well-defined processes to address noncompliance. There is no reason to require auditors to duplicate these established processes. The inquiry-based audit procedures that address noncompliance are well-tailored to identify those areas of noncompliance that should be reviewed by auditors and could require accrual or disclosure in financial statements or SEC filings. When auditors become aware of matters relating to potential noncompliance through these procedures, existing standards further require the auditor to obtain an understanding of the nature of the noncompliance, the circumstances in which it occurred and sufficient information to understand its effect on the financial statements.22

Through these extensive procedures and requirements, auditors are able to gain reasonable assurance that the audit client has responded appropriately to the noncompliance, adopted a reasonable application of ASC 450, and that there is no other effect of the noncompliance that requires disclosure. If the Proposal were to be adopted, its new requirements would undermine these existing procedures and result in needless duplication, increased costs, and no meaningful benefit.

5. The Proposal threatens the audit client’s attorney-client privilege with its internal and external legal counsel.

As noted above, the Proposal would require the auditor to “identify the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements” and to

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21 Although SOX only requires these procedures to address concerns regarding questionable accounting or auditing matters, public companies typically provide for comprehensive whistleblower procedures that allow for the reporting of any type of legal violation.
22 See AS 2405.10.
“identify whether there are instances of noncompliance with laws and regulations that have or may have occurred.”

This expanded audit scope would inevitably lead the auditor to request information from their audit clients to help the auditor assess indications of noncompliance with laws and regulations. In such cases, public companies would have two unpalatable choices to consider with their counsel: (1) voluntarily share privileged information and legal analyses with the auditor regarding noncompliance with relevant laws and regulations, thereby potentially waiving privilege, or (2) refuse to share the requested information with the auditor, in which case the auditor could delay completion of the audit and the filing of the company’s annual report or registration statement with the SEC.

In instances where an audit client shares sensitive and/or privileged information with its auditor, the audit client’s confidential information, which the auditor would include in its workpapers, would be exposed to discovery through requests for audit work papers, which generally are not considered to be covered by privilege. This potential loss of privilege could subsequently jeopardize the company’s legal positions, resulting in increased costs of litigation and ultimately, damage to shareholder value.

**III. Recommendations**

For all of the reasons discussed above, the Society hereby recommends that the PCAOB withdraw the Proposal. If the Board decides nevertheless to proceed with developing a revised proposal on NOCLAR, the Society calls on the PCAOB to first engage in a meaningful dialogue with and obtain input from key stakeholders, such as public companies, their auditors, and outside counsel, and to undertake a rigorous cost-benefit analysis, before presenting any revised proposal.

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As the Board gathers feedback from other interested parties, we would be pleased to facilitate a meeting with Society members regarding the views expressed in this letter.

Respectfully submitted,

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Society for Corporate Governance