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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
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Dear Secretary Brown and Members of the Public Company Accounting Oversight Board ("PCAOB" or the "Board"):

CFA Institute[1], in consultation with its Corporate Disclosure Policy Council ("CDPC")[2], appreciates the opportunity to comment and provide our perspectives on the PCAOB Rulemaking Docket Matter No. 051: *Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations – And Other Related Amendments, PCAOB Release no.2023-003* (the "Proposal").

CFA Institute has a long history of promoting fair and transparent global capital markets and advocating for strong investor protections. An integral part of our efforts toward meeting those goals is ensuring that corporate financial reporting and disclosures and the related audits provided to investors and other end users are of high quality. Our advocacy position is informed by our global membership who invest both locally and globally.

We thank the Board for undertaking this project as part of its ongoing efforts to replace and augment standards adopted from the audit profession. AS 2405, *Illegal Acts by Clients*, was originally issued by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) in 1988. The PCAOB is not a self-regulatory organization; its independence from the profession is embodied in the statutory limitation that no more than two Board members shall be or have been Certified Public Accountants.[3]

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1 With offices in Charlottesville, VA; New York; Washington, DC; Brussels; Hong Kong SAR; Mumbai; Beijing; Abu Dhabi; and London, CFA Institute is a global, not-for-profit professional association of more than 190,000 members, as well as 160 member societies around the world. Members include investment analysts, advisers, portfolio managers, and other investment professionals. CFA Institute administers the Chartered Financial Analyst® (CFA®) Program. For more information, visit www.cfainstitute.org or follow us on LinkedIn and Twitter at @CFAInstitute.

2 The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

3 Sarbanes-Oxley Act, Sec. 101.

We strongly agree with PCAOB Chair Erica Y. Williams that:

> *In the 35 years since 1988, we've seen far too many examples of investors getting hurt due to noncompliance with laws and regulations. We've seen changes in federal securities laws. And we've heard calls from investors for auditors to live up to their responsibilities to ensure financial statements are presented fairly, in all material respects.*[4]

NOCLAR is a Top Priority for Investors: Investors See NOCLAR As Part of Management's and Auditors' Existing Responsibilities under SOX and Related to the Accounting for Contingencies Under US GAAP and IFRS.

Investors Prioritization of NOCLAR – Companies' noncompliance with laws and regulations ("NOCLAR") is an important issue for investors. In our 2018 survey of CFA Institute members, investors rated "Auditor consideration of NOCLAR" as their third-highest priority for audit regulators and standard-setters.[5] (See table to right)

Table 3: What should be the audit standard-setter and regulator priority?

Issue or Topic	Total	High Priority	Medium Priority	Low Priority	Avg Score	Rank by Avg Score
Standards for auditor independence	210	86%	10%	1%	2.88	1
Independence of the governance of audit standard-setting bodies	210	78%	17%	2%	2.78	2
Auditor consideration of noncompliance with laws and regulations	211	73%	20%	3%	2.73	3
Developing and monitoring robust audit quality indicators	209	70%	23%	2%	2.71	4
Audit standards for accounting estimates	209	68%	24%	3%	2.68	5
Going concern judgments and disclosures	211	67%	25%	4%	2.65	6
Audit standards for subsidiary audits	210	57%	30%	6%	2.56	7
Wider adoption of International Standards of Audit (ISAs)	210	52%	27%	8%	2.50	8
Ascertaining appropriate level of assurance on non-GAAP financial measures (NGFMs)	209	51%	33%	8%	2.46	9
Assurance or some other level of auditor comfort on other financial and nonfinancial information	210	44%	40%	8%	2.39	10
Mandatory rather than optional requirements for shareholder ratification of auditor appointment	209	39%	35%	15%	2.26	11
Requiring shareholder voting for audit committee members	210	40%	35%	18%	2.24	12
Assurance or some other level of auditor comfort on preliminary announcements	210	31%	46%	12%	2.21	13

Respondents had four choices: low, medium, or high priority, or no opinion. The weighted average score was determined by assigning 1 to low priority, 2 to medium priority, and 3 to high priority, and excluding respondents who had no opinion.

We believe its high priority reflects the frequency and magnitude of investors losses from NOCLAR through settlements, fines, sanctions, reputational losses with customers, and necessary changes in business models and practices to bring a company into compliance.

NOCLAR can pose existential risks that can result in total losses for investors, such as the fraud committed by Wirecard.[6]

Investors bear the cost of companies' noncompliance but are often the last informed because management is incentivized to withhold negative information from investors entirely or for as long as possible.

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4 Erica Y. Williams, Chair, PCAOB Open Board Meeting, Statement on Proposed New Standard Regarding Noncompliance with Laws and Regulations (June 6, 2023). https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-new-standard-regarding-noncompliance-with-laws-and-regulations

5 CFA Institute. CFA Institute Member Survey: Audit Value, Quality, and Priorities. 2018. https://www.cfainstitute.org/-/media/documents/survey/audit-value-quality-priorities-survey.pdf.

6 Wirecard AG. "Wirecard AG: Application for opening of insolvency proceedings." *Wirecard AG Press Release*, 25 Jun. 2020. https://www.wirecard.com/2020/06/25/wirecard-ag-application-for-opening-of-insolvency-proceedings/. Accessed 4 Aug. 2023.

Investors Make Complex Judgments and Need to Price These Risks – NOCLAR is – as it is for management and auditors – a complex, nuanced issue for investors. Investors appreciate that many instances of potential noncompliance are not black or white and require a decision by a court or other adjudicative body to determine if noncompliance occurred. Investors also understand that legal and subject matter expertise is often required to make complex judgments; investors make similarly complex judgments regularly as they evaluate and price issuers' legal risks in their own investment decisions, often engaging with legal and subject matter specialists themselves.

Investors are not seeking to eliminate all uncertainty, avoid all risks, or to replace management's business judgment with compliance procedures. Rather, investors need accurate, timely, and complete disclosures regarding contingencies to price risks and make appropriate investment decisions.

Investors Rely on Others to Prevent, Detect, Evaluate and Communicate NOCLAR Risks – To overcome management's incentives to withhold negative information and to obtain the disclosures they need to make investment decisions, investors rely on accounting standards, independent auditors, auditing standards, securities laws, independent audit committees, enforcement, and other mechanisms to prevent, detect and communicate non-compliance risks to investments.

Responsibilities and Functions of the Independent Auditor: Providing Reasonable Assurance That Financial Statements Are Free of Material Misstatement – As part of an integrated audit conducted in accordance with the standards of the PCAOB, the independent auditor has a responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, to obtain reasonable assurance about whether material weaknesses exist in the company's internal controls over financial reporting, and to express their opinion to the issuer's board of directors and shareholders.[7]

We note that many responding to the PCAOB's Proposal seem to imply or interpret that the Proposal is asking auditors to provide absolute assurance. This is not the case and not investors expectation.

Existing Standard (AS 2405) is Flawed: It Excludes Audit Work Related to Contingencies Resulting from NOCLAR That Could Result in a Material Misstatement of Financial Statements – A fundamental problem with the existing AS 2405 is that it carves out material misstatements arising from NOCLAR that have an "indirect impact" on the determination of financial statement amounts from the auditor's responsibility. They may be indirect, but still result in a material misstatement of financial statements.

We believe that this flaw effectively results in the exclusion of many types of loss contingency disclosures and accruals under FASB Accounting Standards Codification (ASC) Topic 450,

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[7] AS 1001, *Responsibilities and Functions of the Independent Auditor*; AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*; AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

Contingencies or IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, from the scope of a financial statement audit, beyond obtaining representations from issuer management and counsel.

This was succinctly explained by PCAOB Chair Erica Y. Williams:

> *In fact, [AS 2405] says an audit in accordance with PCAOB auditing standards does not include audit procedures specifically designed to detect all illegal acts that could have a material effect on the financial statements.*[8]

In essence, the auditing standard was developed by the profession for the profession (i.e., the AICPA's 1988 version of AS 2405 adopted by the PCAOB in 2003) to relieve auditors from the responsibility for auditing the completeness assertion inherent in management's disclosure and accrual of contingencies; and hence, the ability of auditors to conclude that the financial statements are free of material misstatement. This exclusion is not communicated to investors and would not be known to investors unless they did a detailed study of auditing standards.

Identification of Contingencies: Already within Scope of Audit and SOX – Procedures to audit management's assertions with respect to contingency disclosures and accruals are well within the scope of an integrated audit and the responsibility of independent auditors – if the financial statements are to be said to be free of material misstatement.

To meet the objectives of an audit, the identification of NOCLAR cannot solely be the function of management. Nor is it sufficient for auditors to rely solely on management representation letters, as that amounts to management "grading their own homework" (i.e., a self-assessment of the financial statements rather than an independent audit).

Like other contingency or liability assessments, NOCLAR is already in the scope of a financial statement audit and an audit of management's internal controls over financial reporting. Management must have processes and internal controls over financial reporting (ICFR), which, through contingencies, includes NOCLAR. Without such controls, management has no basis for their attestations related to ICFR or the disclosures regarding risks and contingencies outside of financial statements covered by their attestation regarding disclosure controls and procedures (DCP) related to Sarbanes-Oxley Act (SOX) sections 404 and 302, respectively.[9]

Some have asserted that the Proposal is placing auditors in the position of management. We do not agree. Management needs a basis for their ICFR and DCP attestations and auditors need to review management's processes and controls to assess the sufficiency of risk and uncertainty disclosures or the accrual of contingent liabilities. This is no different than, for example, an

[8] Erica Y. Williams, Chair, PCAOB Open Board Meeting, Statement on Proposed New Standard Regarding Noncompliance with Laws and Regulations (June 6, 2023). https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-new-standard-regarding-noncompliance-with-laws-and-regulations. Williams cites to paragraph .08 of AS 2405, which states "Normally, an audit in accordance with PCAOB auditing standards does not include audit procedures specifically designed to detect illegal acts."

[9] The Differences Between SOX 302 and 404 Requirements — RiskOptics (reciprocity.com)

assessment of the sufficiency of an insurer's policy liability accrual or a manufacturer's product warranty liability assertions.

We do not view the auditors' responsibilities in this NOCLAR Proposal as a replacement for management's function nor a duplication of management's responsibilities. Rather, we view them as an audit of these internal controls and conclusions regarding NOCLAR.
Some have also commented that investors will be confused by the new standard being developed in the Proposal. The opposite is in fact the case; investors are surprised to learn that an audit does not include work related to assessing contingencies resulting from non-compliance with laws and regulations that could have a material impact on financial statements.

As noted above, AS 2405 – developed by the auditing profession for the auditing profession – created this exclusion. And this exclusion is not communicated to investors by, for example, a note that contingency accruals or disclosures are not audited to the same extent as other financial statement accounts.

We believe the exclusion in the existing AS 2405 is inconsistent – and outdated – with respect to the responsibilities of both management and auditors under US GAAP and SOX. SOX did not exist in 1988 when the existing AS 2405 was developed. The existing standard has not been modernized for the passage of SOX in 2002. This lack of updating has resulted in a failure to modernize not only the audit but all stakeholders thinking with respect to the intersection of SOX and the existing AS 2405 as it relates to NOCLAR. Management representations with respect to NOCLAR are insufficient.

NOCLAR Proposal Relative to Previous Commentary by Members of the PCOAB's IAG

Proposal is Responsive to Long Standing Calls to Address Audit Shortcomings – To provide a reasonable level of assurance to investors with respect to contingencies stemming from NOCLAR, we agree with the Members of the Investor Advisory Group[10] (citing to Guy and Sullivan, 1988)[11] that independent external auditors should:

1. Assume more responsibility for the detection and reporting of fraud and illegal acts,
2. Improve audit effectiveness – that is improve detection of material misstatements,
3. Communicate to financial statement users more useful information about the nature and results of the audit process,
4. Communicate more clearly with audit committees and others interested in or responsible for reliable financial reporting, and
5. Design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.

We believe the Proposal is responsive, in many respects, to these beliefs and to the shortcomings of the existing requirements under AS 2405 and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1 ("Section 10A"). The Proposal is a strong step forward in clarifying the

[10] Letter from Members of the IAG to Office of the Secretary, Public Company Accounting Oversight Board. Docket 051

[11] See Dan M. Guy & Jerry D. Sullivan, The Expectation GAP Auditing Standards, JOA 36-37 (April 1988). Guy was then the vice-president-auditing at the AICPA. And Sullivan was then the chairman of the AICPA ASB and a partner of Coopers & Lybrand where he served as director of audit policy.

responsibilities of auditors with respect to NOCLAR including fraud, which should improve the timeliness and completeness of disclosures to investors so they can better price risks and make appropriate investment decisions.

Shortcomings of Existing Requirements under AS 2405 and Section 10A: The PCAOB IAG's 2017 Recommendations

We strongly agree with the analysis of the shortcomings of the existing requirements with respect to NOCLAR delivered by the Investor Advisory Group on October 24, 2017.[12] The main shortcomings of the existing requirements under the existing AS 2405 and Section 10A are as follows.

1. No assurance is provided to investors with respect to material misstatements arising from noncompliance with laws and regulations that have an "indirect" impact on the determination of financial statement amounts. Many, perhaps most, instances of noncompliance with laws and regulations that result in material losses for investors are related to laws and regulations other than those governing the determination of financial statement amounts. This includes investor losses related to companies' noncompliance in a wide range of areas, such as:
    a. Fraud, bribery, and money laundering,[13]
    b. Public health and safety,[14]
    c. Environmental protection,[15]
    d. Securities markets and trading,[16]
    e. Banking and financial services,[17]
    f. Product liability[18]

    Beyond representations from management, contingency disclosures and accruals required under ASC 450 related to noncompliance with these types of laws and regulations are effectively unaudited.

    Disclosures related to NOCLAR in Items 1. Business; 1A. Risk Factors; and 3. Legal Proceedings filed on Form 10-K with the SEC are also unaudited.

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[12] Report from the Working Group on Auditor's Consideration of a Client's Noncompliance with Laws and Regulations (Oct. 24, 2017), available at https://assets.pcaobus.org/pcaob-dev/docs/default source/news/events/documents/10242017-iag-meeting/wg-slides-noclar.pdf?sfvrsn=7106e876_0

[13] Including the frauds committed by, for example, Wirecard, Enron, WorldCom, and Boeing.

[14] For example, see the master settlement agreement between US states and tobacco companies to recover costs of smoking-related illnesses incurred under Medicaid programs and settlements between US states and pharmaceutical manufacturers, distributors, and pharmacies related to the marketing and distribution of opioids.

[15] For example, the settlements by BP plc for the Deepwater Horizon spill, Volkswagen regarding emissions testing, 3M for "forever chemicals", and recent the allegations made by journalists at the Wall Street Journal against AT&T and Verizon regarding lead cables.

[16] See, for example, settlements by BofA, JPMorgan, and Citi related to sales of residential mortgage-backed securities in the 2000s.

[17] See, for example, settlements and ongoing regulatory and legal proceeding with Wells Fargo regarding the opening of accounts and deficiencies found in the control environment.

[18] See, for example, settlements and ongoing legal proceedings involving Bayer/Monsanto regarding glyphosate and Johnson & Johnson regarding talc powder.

2. The existing standard takes many opportunities to relieve auditors of responsibility with respect to the detection of NOCLAR, making suggestions (uses the word "should" throughout) to auditors, rather than establishing required procedures.[19]

3. There is no mention of procedures to test and evaluate management's processes for detecting and evaluating NOCLAR, such as the existence and effectiveness of processes for tips and complaints, compliance processes, certifications, and trainings, or internal audit functions as part of an integrated audit. Additionally, there are no requirements to seek written representations from lower levels of management or those outside the financial reporting functions with greater visibility into and awareness of NOCLAR.

4. Communication requirements to the audit committee are loose, permitting rationalization around materiality and pre-agreed boundaries of communication.[20]

5. There are no required communications to investors besides a filing, after an auditor resigns, made by the issuer on Form 8-K.[21,22] Investors are the last to know, but first in line to lose money.

Except for the fifth item above, the Proposal addresses the shortcomings of the existing requirements. We believe the clarification and specification of auditors' responsibilities in the Proposal will help close the "expectations gap" by bringing auditors' responsibilities under PCAOB standards more in line with investors' expectations.

We discuss our views on the Proposal in six categories: auditors' responsibilities with respect to NOCLAR identification, evaluation, communication/reporting, the explicit inclusion of fraud in the proposed standard, changes made to the auditing standard on risk assessment procedures and audit planning, and the costs vs. benefits for investors.

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19 *See* generally paragraphs .03, .04, .06 - .08, .10, and .13 - .17 of AS 2405.

20 *See* paragraph .17 of AS 2405: "The auditor should assure himself that the audit committee is adequately informed as soon as practicable and prior to the issuance of the auditor's report with respect to illegal acts that come to the auditor's attention. The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated."

21 Paragraph .23 of AS 2405, "Disclosure of an illegal act to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility…"

22 U.S. General Accounting Office*, Securities Exchange Act: Review of Reporting Under Section 10A*, GAO-03-982R (Washington, D.C.: Sept. 3, 2003). https://www.gao.gov/assets/gao-03-982r.pdf. Page 4.

Identification: Auditors' Responsibilities to Identify NOCLAR in the Proposal

Generally Support Identification Responsibilities – We support the Proposal's requirements for auditors to identify the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements; design and perform procedures to respond to risks of material misstatement of the financial statements due to noncompliance with those laws and regulations; and to identify whether there is information indicating noncompliance with those laws (collectively, "identify NOCLAR").

Direct vs. Indirect: We Don't Oppose the Distinction, Just the Difference in Audit Responsibilities – We strongly support the removal of the distinction in auditors' responsibilities with respect to NOCLAR with a "direct" impact from NOCLAR with an "indirect" impact on the determination of financial statement amounts.

Risks to investors – and material misstatements of financial statements – are not confined to noncompliance with laws that govern the presentation of financial statements. On the contrary, as highlighted above, many high-profile cases of noncompliance that resulted in significant investor losses have been from issuers' noncompliance with laws and regulations that relate more to the respective businesses' operating activities.

Auditors should provide reasonable assurance to investors that management's loss contingency disclosures and accruals are not materially misstated, regardless of the underlying law or regulation that may have been violated.

Auditors may continue to value the distinction between "direct" and "indirect" impact as a mental model in designing procedures, but the risk of material misstatement arising from NOCLAR with an indirect impact on the financial statements cannot be ignored.

Scope Could Be More Clearly Articulated – We share some of the concern raised by PCAOB Members Christina Ho and Duane M. DesParte regarding the scope of the auditor's responsibilities to identify relevant laws and regulations in the Proposal.[23, 24] The threshold of "could reasonably have a material effect on the financial statements" may be too low. In response, we agree with the Members of the Investor Advisory Group and respectfully recommend that the threshold be raised as follows:

> *Identify the laws and regulations with which noncompliance ~~could reasonably have~~ is reasonably likely to have a material effect on the financial statements.*

Such a change would make the scope of the auditor's responsibilities more manageable, focusing auditors on those laws and regulations with which noncompliance is more likely to materially affect the financial statements, and leverage the well-known likelihood threshold in

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[23] Christina Ho, Board Member, PCAOB Open Board Meeting, Statement on Proposed New Standard Regarding Noncompliance with Laws and Regulations (June 6, 2023)

[24] Duane DesParte, Board Member, PCAOB Open Board Meeting, Statements on Proposal to Amend PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments (June 6, 2023).

management's discussion and analysis (MD&A) disclosure requirements under Regulation S-K.[25]

Management's Existing Responsibilities – As we note above, we believe management is responsible for following the law and for detecting, evaluating, and communicating NOCLAR under both SOX Sections 302 and 404. A review of the comment letters posted on the PCAOB website from issuers related to this Proposal indicate that some issuers agree and have compliance programs which are meant to ensure they can meet such obligations. Other letters are less clear on whether issuers see processes and internal controls over NOCLAR as within the existing scope of SOX. We believe they are.

Even if issuers believe NOCLAR is not within the scope of SOX, the standard representation letter required as a part of the audit process includes a requirement (PCAOB AS 2805 Paragraph .06 (o)) that management make the following representation:

> *.06 In connection with an audit of financial statements presented in accordance with generally accepted accounting principles, specific representations should relate to the following matters:……*
>
> *o. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.*

The example representation letter in AS 2805 highlights the following as the standard representation received by auditors from management:

> *There are no—*
>
> *a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.*

Whether covered by SOX or as a necessary step in being able to provide the management representation letter, management needs to have processes and internal controls associated with the identification – and evaluation for disclosure or accrual – of contingencies associated with NOCLAR.

NOCLAR, and managements' related controls and compliance processes, are governance issues. Financial reporting, maintaining effective internal controls, and following the law are all responsibilities of management. Auditors are simply being asked to provide investors with *independent checks* on those efforts. Unlike management, auditors do not and should not have an incentive to keep negative information from investors.

A review of the comment letters received from issuers by the PCAOB on the Proposal suggest varying levels of management sophistication regarding their compliance programs and the processes and internal controls regarding ensuring compliance with laws and regulations. Additionally, there currently appear to be varying degrees of auditor engagement and testing on compliance functions. Some issuers indicate the Proposal will either: require they change their

[25] 17 CFR 229.303(a), "The discussion and analysis must focus specifically on material events and uncertainties known to management that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating results or of future financial condition."

compliance programs; cause auditors to do the work in place of management work; supersede management's judgement; or create additional costs. We cannot identify which provisions of the Proposal they are looking to in reaching those conclusions.

If the Proposed Standard is Not Fully Adopted, Then Object to Changes to AS 2805, Management Representations – The Proposal adds a footnote (footnote 10) to AS 2805, *Management Representations*, that seeks to clarify the role and scope of management's representation letter. While we do not object to the addition of this footnote, if this version of the Proposed AS 2405 is adopted, we do object to this footnote on a standalone basis because it weakens the existing standard. Indicating that the auditor is *"not asking for management's speculation on all possibilities of legal challenges to its actions"* and that the representation concerns *"matters that have come to management's attention and that could reasonably have a material effect on the financial statements and should be considered in determining whether financial statement disclosures or the recording of loss contingencies are necessary"* excessively caveats management's responsibility, rendering the representation impotent. We fear that management would use this footnote as a "safe harbor" from communicating with auditors and from accountability more broadly.

Expansion of Scope Beyond Existing Boundaries – We do not believe that the Proposal expands the scope of the audit far beyond its existing boundaries or auditors' core competencies, nor do we believe it is redundant with management's responsibilities. As we outline above, the proposed requirements are closely related to auditors' existing responsibilities to obtain an understanding of an issuer's regulatory and business environment, and to test management's controls for contingency disclosures and accruals in an audit of internal controls over financial reporting.

That said, we believe the PCAOB may need to refine the language in Paragraphs .05 and .06.

Paragraph .05 of the proposed revised standard indicates:

.05 The auditor must plan and perform procedures to:

a. Identify the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements;

b. Assess and respond to risks of material misstatement of the financial statements due to noncompliance with those laws and regulations; and

c. Identify whether there is information indicating noncompliance with those laws and regulations has or may have occurred.

While Paragraph .06 of the proposed revised standard indicates:

.06 As part of planning and performing procedures in accordance with paragraph .05, ***the <u>auditor must use the information obtained</u> from****:*

a. Risk assessment procedures, including:

1) ***Obtaining an understanding of the company and its environment, including the regulatory environment*** *(see paragraphs .07-.15 of AS 2110, Identifying and Assessing Risks of Material Misstatement [as proposed to be amended]);*

2) ***Obtaining an understanding of management's processes related*** *to*
(i) ***identifying laws and regulations with which noncompliance could reasonably have a material effect*** *on the financial statements;*

(ii) ***preventing, identifying, investigating, evaluating, communicating, and remediating*** *instances of noncompliance with laws and regulations;*
(iii) ***receiving and responding to tips and complaints from internal and external parties*** *regarding noncompliance with laws and regulations; and*
(iv) ***evaluating potential accounting and disclosure implications of noncompliance*** *with laws and regulations, including fraud (see AS 2110.26 [as proposed to be amended]);*

3) ***Making inquiries of management, the audit committee, internal audit personnel, and others regarding noncompliance with laws and regulations*** *(see AS 2110.54 and .56-.58 [as proposed to be amended]); and b. Other procedures performed in the audit of the financial statements, in reviews of interim financial information, and, if applicable, in an audit of internal control over financial reporting that may identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements or noncompliance with laws and regulations that has or may have occurred. Note: AS 2301, The Auditor's Responses to the Risks of Material Misstatement, an*

It appears those indicating that the auditors' scope has widened – without a need to consider the work of management – are looking to the language in Paragraph .05 without consideration of the requirement in Paragraph .06 which states that auditors *must* use the information obtained from management in the subparagraphs which includes their risk assessment, identification, evaluation, and communication of non-compliance with laws and regulations.

As we consider much of the narrative in opposition to the Proposal, it appears many believe the auditors work must be entirely substantive and without consideration of existing processes and controls employed by management – and done with the goal of achieving absolute, rather than reasonable, assurance related to NOCLAR.

As we believe (i.e., and as some issuers comment letters indicate) NOCLAR is already within management's scope of responsibility under SOX to maintain processes and internal controls to ensure compliance with laws and regulations, support risk and contingency disclosures, and support attestation requirements; we think the PCAOB needs to recognize this obligation of management and to indicate that auditors responsibilities include assessing the completeness and sufficiency of management's existing risk assessment, process and internal controls around NOCLAR, and performing whatever additional procedures are necessary to ensure the financial statements are not materially misstated. We believe the PCAOB needs to make it clear that reliance on management representation letters – especially where there is no work to support that representation – is insufficient.

Evidence-Based Standard Setting – As noted above, as we considered the responses from issuers, we believe there is likely significant variability in management compliance functions and auditor testing of such compliance functions. We believe the PCAOB should use its inspection function to inform its standard setting in this area. Specifically, we believe the PCAOB should review auditor workpapers during the inspection process with the objective of better understanding the level of underlying work currently completed by auditors and the nature and quality of the underlying compliance programs of companies being audited. This would inform their standard setting.

The Use of Specialists: Auditors Are Not Lawyers, But Lawyers are Just Another Type of Specialist – Many have asserted that the Proposal is not workable because auditors are not lawyers and therefore will not be able to identify or evaluate NOCLAR. While it is true that auditors are not lawyers, auditors currently receive and review legal letters from outside counsel as part of their audit work and they discuss and evaluate the sufficiency of legal contingencies currently. How are they performing such procedures today?

Auditors use a plethora of specialists on audit engagements including, but not limited to security valuation specialists; business valuation and impairment specialists; actuaries; tax specialists; pension actuaries; and compensation and benefits specialists. As the Proposal indicates, most audit engagements in 2021 involved the use of an auditor-employed or auditor-engaged specialist, including 95 percent of U.S. global network firm engagements. Investors acknowledge that specialists, including lawyers, may be required, but that would not be a categorical change from the existing use of specialists as part of the audit.

Further, audit firms are increasingly marketing assurance and other related services for environmental, social, and governance (ESG) issues. Assurance over such risks is likely to require the use of an even broader range of specialists – including the "G" (governance) which is often the domain of lawyers and, in many respects, related to NOCLAR. Further, ESG assurance in many jurisdictions will require the assessment of many risks not traditionally in the domain of auditors and with a requirement to not only consider financial but double materiality (i.e., an especially challenging and subjective assessment)

For these reasons we believe that "auditors are not lawyers" is a non sequitur in opposing the Proposal.

CFA Institute

Evaluation: Auditors' Responsibilities to Evaluate NOCLAR in the Proposal

Support Required Procedures and Guidance – First, we support the proposed standard's *requirement* for the auditor to perform procedures in Paragraphs .07 and .09 ("the auditor *must*") and the specification of examples of those procedures in Paragraphs .08 and .10. This is an improvement over AS 2405, which merely *suggests* that auditors perform procedures.

Recommend Language Revisions – We believe the proposed requirements – to determine if NOCLAR occurred – in Paragraphs .07 and .08 could be improved with amendments to lower the risk of an unacceptably wide range of views on what is expected from the auditor.

We respectfully recommend changing the proposed requirements:

- from the auditor alone evaluating (i.e., after a potential instance of NOCLAR has been identified) whether a possible instance of NOCLAR has occurred and whether a contingency or disclosure is required;

- to the auditor being required to refer a potential instance of NOCLAR, unless clearly inconsequential to the appropriate level of management for evaluation, and then to the audit committee if management's evaluation is insufficient. When an identified instance of NOCLAR is judged by the auditor to be potentially material or if senior management is implicated – it should be required to be communicated to the audit committee for an initial assessment and evaluation.

This would remove any doubt that auditors are performing a management function that impairs their independence under Regulation S-X and would reduce the need for specialized legal expertise by the auditor.

Requirement to Perform Additional Procedures Regarding Other Information – We strongly support the requirement for the auditor to perform additional procedures in Paragraph .09(b) as necessary to determine: *"whether the likely noncompliance … results in other information in documents containing audited financial statements, or the manner of its presentation, being materially inconsistent with information appearing in the financial statements or containing a material misstatement of fact."*

Some indicate that this provision Paragraph .09(b) extends the existing requirements in AS 2710, *Other Information in Documents Containing Audited Financial Statements*. We disagree and find the language in Paragraphs .04 and .05 of AS 2170 is consistent with the provisions of Paragraph .09(b) of the proposed standard. The explicit mention of these procedures may have the added benefit of improving the timeliness and completeness of disclosures to investors in, for example, Items 1. Business, 1A. Risk Factors, and 3. Legal Proceedings filed on Form 10-K with the SEC.

Further, the argument against this revision is similar to the argument recently made against *Proposed Auditing Standard – General Responsibilities of the Auditor in Conducting an Audit and Proposed Amendments to PCAOB Standards* (PCAOB Rulemaking Docket Matter No. 049) with respect to the notion of "fairly presents". In our comment letter to that proposal we similarly refute that assertion.

Communication:
Auditors' Responsibilities to Communicate and Report NOCLAR in the Proposal

Overall, we support the proposed improvements to the communication and reporting of NOCLAR but believe there are two specific areas that could be improved. The first is refining the thresholds for auditors' communication of potential instances of NOCLAR to management and the audit committee. The second is that communications to investors by the auditor or audit committee related to NOCLAR are absent from the requirements in Paragraphs .12 to .15.

Refining Thresholds for Audit Committee and Management Communications – Paragraph .12 of the proposed standard requires the auditor to communicate potential instances of NOCLAR, regardless of materiality, to the appropriate level of management and, unless clearly inconsequential, to the audit committee. Additionally, the proposed standard notes that the auditor should presume that a matter involving senior management is *not* clearly inconsequential.

To better focus management and the audit committee's attention on matters material to investors and to ensure that auditors are not overburdened with communication requirements, we suggest the following alternative thresholds for communication:

- Auditors must communicate potential instances of NOCLAR, unless clearly inconsequential, to the appropriate level of management. Also, as we note above, management must evaluate these potential instances and auditors must be satisfied with that evaluation. If they are not, this should be communicated to the audit committee.
- Auditors must communicate potential instances of NOCLAR that are material to the financial statements to the audit committee. All potential instances of NOCLAR involving or implicating senior management, regardless of materiality, must be communicated to the audit committee.

Communication With Investors (NOCLAR As a Critical Audit Matter) – Based on the volume of dissent from critics of the Proposal with respect to how onerous the requirements of the Proposal are expected to be, we believe procedures to identify, evaluate, and communicate NOCLAR undoubtedly meet the requirement for a critical audit matter (CAM) to be communicated to investors.

The degree of dissent to the PCAOB's Proposal also makes investors wonder whether there is already a need for auditors to communicate regarding how they assess the completeness of contingencies under existing accounting and auditing standards.

We respectfully recommend the Board explicitly remind auditors in the proposed standard regarding the critical audit matters requirement. For example, through including language in the Proposal such as "the Board presumes NOCLAR, especially for issuers in highly regulated industries, is a critical audit matter" with a citation to the reporting requirements related to CAMs in AS 3101.

Communication to Investors Before Resignation – Additionally, we recommend that an additional communication requirement be added to the proposed standard such as: "communication to investors from auditors is necessary *before* they resign from an engagement resulting from a material NOCLAR that management is unable to or unwilling to remediate." Resignation by an auditor because of an unremedied NOCLAR event is something investors must understand, and existing Form 8-Ks are uninformative as to the reason for the auditor resignations.

Explicit Inclusion of Fraud in the Proposal

We believe the inclusion of fraud in this standard is logical and appropriate because fraud is an intentional form of noncompliance. Further, it is often a trigger for fraud lawsuits by investors, so they are closely related.

NOCLAR & Fraud Standards Should be Separate but Work in Concert – We do not disagree that fraud is, and should be, the subject of its own standard-setting project. However, in its work on the proposed fraud standard, we strongly recommend that the PCAOB ensures that the fraud standard works in concert with the NOCLAR standard by minimizing overlapping or contradicting procedures and objectives.

Intentional Nature of Fraud & Those Perpetrating Should be A NOCLAR Risk Indicator – Fraud is an intentional misstatement in financial reporting or misappropriation of assets and differs from other types of NOCLAR in this Proposal in certain respects. Investors are often the primary and intended victims of fraud and significant fraud speaks greatly to the integrity of management and the "tone at the top," especially in cases involving senior management. A CEO of a large company stealing a few million dollars per year might be immaterial to the financial statements but highly material to investors' decision-making and to the approach auditors should take to the execution of their efforts and materiality determinations across the audit. Investors believe that materiality determinations should be adjusted downward when there are senior management frauds or a tone from management that makes it clear that existing processes and internal controls may be overridden.

Changes to AS 2110: Identifying and Assessing Risks of Material Misstatement

We strongly agree with the Board's proposed changes to AS 2110*, Identifying and Assessing Risks of Material Misstatement,* that recommend auditors read publicly available information disclosed by a company, its executive officers, as well as information about the company reported by the media and analysts. Keeping up to date on this information is essential to understanding investors' perspectives and assessing the risk of material misstatement for the company overall, as well as in specific areas (e.g., a particular segment or geography) that may deserve increased auditor scrutiny.

We believe the Proposal can be strengthened by: (1) *requiring* rather than recommending auditors read publicly available information about and disclosed by the company; (2) adding "short sellers' reports and related information" to the list of examples of external sources that auditors read in Paragraph .11 of AS 2110; and (3) adding "past regulatory investigations, settlements, and penalties" as a bullet point in Paragraph .15 of AS 2110. Short sellers' reports and past regulatory actions are a rich source of information for auditors in identifying and evaluating the risk of material misstatement from NOCLAR and fraud.

Cost/Benefit Analysis

Too Costly: A Common Refrain – Some critics of the Proposal are certain the cost of implementing this Proposal will be exorbitant and there will be more harm than benefit to investors. Both the cost and economic detriment arguments are common refrains investors hear and are regularly used to defer or cease progress on issues of importance to them. The projected costs and economic detriment never manifest in the degree projected by those opposed to the changes. Further, the reality is that investors are the ultimate arbiter of the cost-benefit of the Proposal as they – as owners of the company – pay the cost of the change and compliance from both the company and auditor perspective. In most instances those opposing the changes due to cost considerations are not the ones ultimately bearing the costs.

Consider, for example, several previous instances of this same argument:

- *Implementing SOX: Internal Controls Over Financial Reporting (ICFR)* – Some critics of the Proposal are certain that it will cost investors more, in the form of increased audit fees and issuers' costs of compliance, than the Sarbanes-Oxley Act (adjusted for inflation). Investors widely believe the cost of SOX has been worth it and they are aware that this needs to be priced through a risk premium in required rates of return in jurisdictions – such as the UK and Europe – where SOX like testing of internal controls does not exist.
- *Expensing of Stock Options* – The same scenario played out when the FASB sought to expense stock-based compensation at fair value. Those in the technology sector indicated the valuations were not reasonable and predicted the end of innovation in the US technology sector.[26] Obviously, that did not happen. At the time, CFA Institute advised that investors were already pricing this dilution, and simply needed better information to more accurately do so. We also communicated that it would be more cost effective if each company rather than all investors individually made such estimates.
- *Balance Sheet Recognition of Lease Obligations* – The leasing industry and preparers argued that recognizing operating lease assets and liabilities on balance sheets would result in the demise of the leasing business, have a chilling effect on the economy, and result in unreasonable costs (i.e., they did not have systems to track the leases – an assertion which led investors to believe that issuers' existing lease footnote disclosures were inaccurate).[27] The leasing industry did not end, the detrimental economic effects were not as projected, and technology to track leases and capture relevant information was either suddenly invented or had existed all along. Again, CFA Institute advised that investors were already measuring

[26] Expensing Stock Options: Can FASB Prevail? - Knowledge at Wharton (upenn.edu)

[27] See articles and comments letters such as:
2010: Chamber of Commerce letter to FASB
(0104- 1850-100 CCMC US CHAMBER OF COMMERCE THOMAS QUAADMAN (fasb.org))
2013: Chamber of Commerce letter to FASB
(LEASES2.ED.0010.CCMC U.S. CHAMBER OF COMMERCE SEE LISTED (fasb.org))
2013: FEI letter to FASB
(LEASES2.ED.0002.FINANCIAL EXECUTIVES INTERNATIONAL MARIE N. HOLLEIN (fasb.org))
2015: Compliance Week Article Regarding Congressional Views
(FASB, Congressman Dispute Lease Standard's Economic Effect | Blog | Compliance Week)

these liabilities, they simply needed better information to make such estimates and it would be more cost effective if each company rather than all investors individually making such estimates.

We provide these examples because they are important for the PCAOB to consider for context. The overly burdensome costs without benefit and the projected economic detriment rarely manifest as prognosticated.

Cost Analysis Needed – We do, however, respectfully recommend that the PCAOB conduct or commission a quantitative cost estimate for the Proposal with an analysis to understand which changes are the largest cost drivers (i.e., is it in NOCLAR identification, evaluation, or in reporting/communication) and to evaluate the cost to investors of *not* making the improvements. Traditionally the cost-benefit analysis always focuses on the cost to preparers of generating the information or auditors of auditing the information but not the cost to investors of having to make their own analysis of the risk of not obtaining the information or making their own estimates.

Technology Needs to Be Considered – We also think it is essential that any cost/benefit analysis consider the deployment of technology to identify relevant laws, track their compliance and compile and report results by both management and the auditor. Information technology has advanced considerably since the existing AS 2405 standard was written in 1988.

Existing Management Controls – The responses to the PCAOB's Proposal comes across to investors as suggesting (i.e., by some issuers or their advocates) that they have no existing processes or internal controls over noncompliance with laws and regulations (in a similar manner to their objections over accounting standard changes such as leases). Management should already have risk assessment and processes to ensure non-compliance with such laws and regulations as part of their risk management and governance processes. As such, we wouldn't view these costs as incremental and attributable to the PCAOB's Proposal when performing such cost-benefit analysis. We believe the PCAOB should bear this in mind in performing any cost analysis.

The Impact on Smaller Audit Firms – Critics of the Proposal have also repeated the common refrain that the costs of stronger auditing standards will harm smaller audit firms, potentially driving them out of the market for issuer audits, resulting in greater market concentration. We believe that stronger auditing standards result in higher quality audits, which benefits investors. There is no evidence that concentration in the issuer audit market has increased fees or decreased audit quality.[28] On the other hand, there is evidence of lower audit quality in engagements involving smaller issuers and audit firms: since 2005, the vast majority of restatements have been made by non-accelerated filer registrants, with these issuers accounting for 73% of restatements in 2021.[29]

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28 *Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action.* United States Government Accountability Office. January 2008. https://www.gao.gov/assets/gao-08-163.pdf

29 Financial Restatements: A Twenty-One Year Review. Audit Analytics, May 2022. https://www.auditanalytics.com/doc/2021_Financial_Restatements_A_Twenty-One-Year_Review.pdf

Further, we do not believe the PCAOB has an obligation to ensure the sustainability of smaller audit firms over the interests of investors, nor do we believe that auditing standards are the proper venue for addressing these concerns. By analogy, should new drugs, technology, and treatment guidelines that benefit patients not be launched or adopted for fear that certain doctors and smaller practices are incapable of offering them? If there are concerns about audit market concentration, such as the market power of the Big Four, those should be relayed to the Federal Trade Commission, Department of Justice, and/or Congress for antitrust consideration, as appropriate.

Due Process in PCAOB Standard-Setting

We respectfully echo the concerns raised by some other commenters regarding the timeline for stakeholder comment and, more broadly, transparency in the Board's standard-setting activities. It is challenging for us to constructively respond to a significant rulemaking proposal in 60 days.

We recommend that the Board publicly debate, prior to their issuance, proposed standards like NOCLAR when such documents have not been previously exposed to allow time for stakeholders to become familiar with the issues being debated or considered. While we recognize and respect the PCAOB's desire to make progress on its agenda setting, this would enable us to best respond to the Board's proposals by, for example, fielding a tailored survey to our member base of investors.

With respect to this proposed NOCLAR standard, we strongly recommend the PCAOB convene a roundtable with appropriate stakeholder representation. We believe this would allow the PCAOB to receive feedback that is more balanced by stakeholder type (the comment letters on the PCAOB's website to date are overwhelmingly from preparers and their representatives) and may help stakeholders better understand the PCAOB's intended outcomes.

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Thank you for your consideration of our views and perspectives. We would welcome the opportunity to meet with you to provide more detail on our letter. If you have any questions or seek further elaboration of our views, please contact Sandra J. Peters at sandra.peters@cfainstitute.org and Matthew P. Winters at matt.winters@cfainstitute.org.

Sincerely,

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