



March 18, 2024

Erica Y. Williams, Chair
Office of the Secretary
Public Company Accounting Oversight Board
1666 K St. NW
Washington, DC 20006-2803
comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 051

Dear Ms. Williams:

The Pennsylvania Institute of Certified Public Accountants (PICPA) appreciates the opportunity to provide input on the Public Company Accounting Oversight Board's (PCAOB) questions and topics included in the roundtable briefing paper for the Proposed Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations. The PICPA is a professional CPA association of about 20,000 members working to improve the profession and better serve the public interest. Founded in 1897, the PICPA is the second-oldest CPA organization in the United States. Membership includes practitioners in public accounting, education, government, and industry. The PICPA's comments are included below.

General Comments

Given the importance of this topic, we request that the PCAOB re-expose the proposal after revisions to ensure that the final language is viable. The scope of the original proposal was significantly beyond what is reasonable and would have dramatic ramifications on the audit and, consequently, the capital markets.

Many roundtable participants seemed to agree that auditors would not be expected to sit at the side of a river to identify instances in which a company was illegally dumping toxic waste, but the wording in the proposal indicates otherwise. Specifically, proposed AS 2405.04 a. includes the objective "to identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements," and proposed AS 2405.04 c. includes an objective to "identify whether there are instances of noncompliance with laws and regulations that have or may have occurred." Clearly, illegal dumping of toxic waste could lead to a material noncompliance with laws and regulations (NOCLAR). Auditors cannot be required to provide assurance that *no material NOCLAR* has occurred that hasn't been accrued or disclosed in the financial statements. Roundtable participants continued the discussion as if the scope had been resolved or was only a minor issue. We do not believe this has been resolved: the scope of the proposal is the definitive issue and our main concern.

The wording of the standard must clearly articulate the scope. The profession cannot rely on roundtable discussions to inform the scope of audits. Accordingly, we expect a significant change to the scope of the proposed PCAOB revision to the NOCLAR standard, and we look forward to future opportunities to evaluate PCAOB's proposed revisions. If the scope of the proposed requirement is not curtailed to maintain the auditor's focus on the financial statement ecosystem, we believe the PCAOB should conduct a feasibility study,

a formal cost/benefit analysis, an evaluation of the impact on independence standards, a legal analysis to ensure the final standard does not undermine attorney-client privilege, an analysis of the legal liability on auditors, and an evaluation of its effect on the auditor pipeline. We believe that the March 6, 2024, roundtable discussion was an excellent start to inform any revisions to the NOCLAR standard, but significant work remains.

Responses to Specific Questions

Topic: Threshold for Identification of Laws and Regulations

1. *Are there other thresholds besides “could reasonably have a material effect” that would provide sufficient rigor to the auditors’ identification of laws and regulations relevant to the audit of a company’s financial statements?*

The concept of “sufficient rigor” included in the first question is vague, leading to a lack of clarity regarding its overall objective. We acknowledge that there could be misunderstanding by financial statement users with respect to their expectations of what an auditor’s work entails and the work that the standards require. To the extent that investors see instances of material NOCLAR that were not identified by the auditor, there could be confusion surrounding the auditor’s work and related opinion. We agree that this conversation is important to ensure that audit work is within appropriate parameters and that there is clarity among financial statement users regarding the overall limitations of the audit. Auditors, as we know, do not provide *absolute assurance* and cannot be responsible for detecting *all instances* of NOCLAR.

The PICPA supports enhancing audit standards through improvement to the risk assessment standards and additional supporting guidance, as well as changes to the audit report that would clarify the limitations of the audit as follows:

- Revise the audit report to clearly articulate for investors that auditors are not in a position to detect all instances of NOCLAR, including fraud, that are material to the financial statements. The scope of an expectation to find all instances would be unreasonable, leading to excessive work surrounding every law and regulation around the globe.
- Add risk assessment procedures that incorporate a greater understanding of a company’s regulatory and compliance processes, including inquiries into the company’s key compliance personnel, follow-up inquiries into compliance areas with a higher risk of material NOCLAR, and reading publicly available information from credible sources. By gaining a greater understanding of a company’s risk management processes, we believe auditors can better identify those laws and regulations that could have a greater impact on financial statements. We also support enhancing the dialogue between the auditor and the audit committee surrounding the company’s compliance program, including understanding the company’s whistleblowing procedures and evaluating whether additional testing is warranted.

The PICPA does not support any change in the threshold for the detection of laws and regulations that goes beyond Section 10A of the Exchange Act, which requires audit “procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of

financial statement amounts.” On page 41 of PCAOB’s Release No. 2023 - 003, the discussion indicates that the threshold for the auditor’s evaluation of NOCLAR is similar to the Section 10A threshold, which is when the firm detects or otherwise becomes aware of information indicating that an illegal act has or may have occurred. We believe that the PCAOB threshold would be more rigorous because it applies to all NOCLAR, requiring the auditor to identify, rather than simply follow up, when the auditor becomes aware of an illegal act.

- 2. What types of specific procedures should the auditor perform to identify the laws and regulations? Are any of these procedures already required, at least in part, by Section 10A of the Exchange Act or procedures required by existing PCAOB standards? Should auditors be able to consider the work of management in identifying laws and regulations and, if so, how?*

Company management and its legal counsel are primarily responsible for identifying laws and regulations. While incremental enhancements to the standards to incorporate these procedures is reasonable, we do not believe that auditors’ responsibilities should be expanded to include performing an analysis of all laws and regulations, noncompliance with which could have a material impact on the financial statements, and concluding that no NOCLAR occurred during the financial statement period.

Auditors could perform inquiry procedures of legal and regulatory compliance professionals and the audit committee, review legal letters, review publicly available news sources, and remain alert throughout the audit as to whether there is any potential NOCLAR. Per the PCAOB’s AS 2505: Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments, “A letter of audit inquiry to the client’s lawyer is the auditor’s primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.”

- 3. What potential approaches in the standard would facilitate auditors in identifying such laws and regulations (e.g., factors to determine the relevant population of laws and regulations; factors that relate to the risk of material misstatement due to noncompliance with laws and regulations)?*

The question refers to identifying “such laws and regulations” and “determining the relevant population of laws and regulations.” However, the proposal does not clearly articulate the parameters as to what these represent, except to say that they represent all laws and regulations. The scope further does not limit the period for which the auditor must make this determination, therefore requiring the auditor make predictions about future settlements that a client’s own legal counsel may be unable to make. The scope of the proposal is untenable.

There are potentially thousands of laws and regulations of which violations could have a material impact. As further discussed in our key issues summary, auditors are not compliance experts and would have insufficient expertise to make judgements on complex regulatory and compliance requirements. We believe that the proposed standard should be revised to focus the auditor’s attention on laws and regulations having a direct impact on financial statements.

Topic: Direct Illegal Acts vs. Indirect Illegal Acts

1. *Given that noncompliance with both direct and indirect laws and regulations can result in material misstatements of the financial statements, what is your view of the direct/indirect distinction under the current PCAOB auditing standard?*

The current distinction between direct and indirect laws and regulations under the current PCAOB auditing standards is critical to a high-quality financial statement audit. Therefore, the PICPA supports retaining the threshold requiring the auditor to identify NOCLAR having a direct and material effect on the financial statements and retaining the language that “an audit made in accordance with PCAOB auditing standards provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed.”

- a. Financial statement auditors are not compliance experts or attorneys.

Changing the focus of the auditor from the direct laws and regulations under the current PCAOB auditing standards would vastly broaden the scope of an audit to include legal and compliance audits for all laws and regulations to which a company is subject. Auditors would be required to analyze and perform additional audit procedures over every regulatory compliance area within a company, plus the thousands of laws and regulations that exist at the federal, state, and local levels that could impact the company. This scope is clearly outside the expertise of auditors, who are experts in financial statements and internal controls over financial reporting. While the PCAOB’s proposal would contemplate the use of specialists to augment auditors’ capabilities, the breadth and number of specialists would be staggering, and it would still put the auditor in the position to render the final opinion. Requiring auditors to make complex legal judgments is *not in the best interest* of capital markets and could constitute the unauthorized practice of law.

- b. Auditor independence.

Auditor independence is fundamental to the effectiveness of an audit. Auditors cannot assume management’s responsibilities without breaching independence requirements. Management and the board ultimately are responsible for identifying, implementing, and operating an effective system of internal controls to prevent and detect NOCLAR directly related to the preparation of the financial statements. The proposed standard would have the auditor identify all NOCLAR and instance of NOCLAR that could reasonably have a material impact on the financial statements. The proposal requires a broader scope for the auditor than is required of management and the board. This responsibility cannot, and should not, be shifted to the auditor. The proposed requirement would result in auditors potentially performing a management function, of which they must remain independent.

Furthermore, it is unclear how differences of opinion would be settled. If the auditor’s legal experts and the client’s legal counsel disagree regarding the potential outcome of litigation or the impact of a regulatory compliance issue, this could impair independence due to an adverse interest threat. On the other hand, if the auditor’s legal specialist agrees with the company’s legal counsel on a legal matter,

this may become an independence impairment due to perceived client advocacy. What if the auditor's analysis becomes a part of a client's court case? This proposal could force auditors into taking positions that could result in breaching independence rules.

- c. Providing assurance on the outcome of future regulatory actions or legal conclusions is not possible. The constantly changing regulatory environment, unpredictability of the legal system, and future actions of the client and the client's legal counsel make divining future outcomes of a company's NOCLAR beyond the ability of auditors.

The response of the American Bar Association (ABA) to the PCAOB's NOCLAR proposal notes the following: "The Proposed Standard also contemplates that the auditor would have to identify laws and regulations that are relevant for purposes of the standard on a prospective basis – i.e., the auditor must identify those laws and regulations that could (i.e., in the future) reasonably have a material effect on the financial statements and then must continue through the remaining steps of the proposed standard. Not only does the Proposed Standard expressly require the auditor to render prospective legal judgments as to where noncompliance could have a material impact in the future, even indirectly, the Proposed Standard also provides no time horizon as to how far into the future the auditor would have to look in making this speculative judgment of potential materiality."¹

Furthermore, in many instances auditors receive legal letters from attorneys in which the response is restricted due to uncertainties, lack of competence, lack of historical experience, etc. It is unclear how an auditor could make conclusions on such uncertainties if they cannot be opined on by an attorney.

From the PCAOB's guidance: "AS 2505: Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments, Para. .14– A lawyer may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss, because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome may sometimes not be within a lawyer's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available; and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, a lawyer may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor ordinarily will conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event which is not susceptible of reasonable estimation, and should look to the guidance in AS 3105.28 through .32 to determine the effect, if any, of the lawyer's response on the auditor's report."

2. *How are auditors and management assessing violations of an indirect law or regulation that results in a contingent liability that, when not correctly recorded or disclosed, misstates the financial statements? Does the direct or indirect nature of the law violated matter to this assessment?*

¹ American Bar Association Business Law Section Response to PCAOB Docket Matter No. 51 dated August 23, 2023
https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket-051/134_aba-bls.pdf?sfvrsn=b0454185_4

Auditors makes inquiries of management and a client's legal counsel to evaluate litigations, claims, and assessments in accordance with AS 2505: Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments; communicate with the audit committee and review minutes; read publicly available news pieces; and obtain management representation letters. When auditors come across evidence that a fraud may have occurred, the auditor obtains an understanding of the nature and surrounding circumstances of the possible noncompliance, and sufficient information including supporting documentation to determine the impact on the financial statements. The auditor then communicates with those charged with governance and may make further inquiries of external legal counsel. Auditors will then have to evaluate whether disclosures outside of the entity are required.

The required audit steps do not vary based on the direct or indirect nature of laws violated. However, the affirmative requirement to identify the NOCLAR would change the audit requirements considerably. Furthermore, the auditor would rely on the client's legal counsel to provide legal conclusions.

Topic: Competence to Assess Relevant Noncompliance with Laws and Regulations

1. *How are auditors currently complying with the existing requirements of Section 10A(b)(1)(A)(i), which requires auditors to determine whether it is likely that an illegal act has occurred, when the firm detects or otherwise becomes aware of information indicating that an illegal act has, or may have, occurred?*

The answer to this question is clearly spelled out in Section 10A(b)(1)(A)(i). Specifically, if, during the course of the audit, the auditor becomes aware of or detects information indicating that an illegal act has occurred, the auditor determines whether it is likely that an illegal act has occurred and, if so, the possible effect of the illegal act on the financial statements including the amount, and informs the appropriate level of management, the audit committee, or board of directors. The auditor then evaluates the response taken by those charged with governance. If none are taken and the illegal act has a material financial statement impact, there would be a departure from a standard report or the auditor would resign. In that event, the board would notify the Securities and Exchange Commission (SEC).

However, SEC guidance is predicated upon the firm detecting or otherwise becoming aware of information during the course of performing the audit. The proposed PCAOB guidance would require firms to perform specific procedures to detect noncompliance.

2. *When an auditor detects, or otherwise becomes aware, that an illegal act may have occurred, does the evaluation of a potential illegal act differ with respect to direct and indirect laws and regulations? What are those differences in the evaluation process?*

We do not believe that the required evaluation would differ with respect to direct and indirect laws and regulations. However, we disagree with any expansion of the requirement to identify any indirect NOCLAR that could be material to the financial statements.

3. *When an auditor has identified, or otherwise becomes aware of, a potential illegal act, what is the interaction between the auditor and those hired or employed by the company to perform an investigation? For example, do auditors evaluate the work performed by such personnel as part of performing their*

assessment? If so, what does such an evaluation entail? Do auditors have input into how the investigation is conducted for purposes of its sufficiency for the audit? Do auditors receive debriefings on interviews of key witnesses in such investigations?

Auditors rely on a legal counsel to provide information on loss contingencies and updates on potential illegal acts. The ABA has clear guidance to ensure that the auditor receives enough information to comply with the financial reporting requirements without violating attorney-client privilege.

- 4. What specific auditing procedures can auditors perform to identify and assess either (1) laws and regulations with which noncompliance could reasonably have a material effect on a company's financial statements or (2) the related assessment of the risk of material misstatement that are within the auditor's skillset (e.g., reading relevant minutes, inquiring of compliance personnel, examining whistleblower hotline records, reading regulatory correspondence)?*

Auditors could perform risk assessment procedures, analytical review procedures, and read publicly available information, and could perform inquiry procedures to enhance their awareness of potential laws and regulations with which noncompliance could reasonably have a material effect on a company's financial statements. However, regardless of the additional procedures performed by the auditor, no amount of audit procedures could ensure the detection of all NOCLAR that could possibly have an impact on the company's financial statements. The proposed scope is too broad.

Topic: Concerns Regarding Potential Waiver of Attorney-Client Privilege

- 1. In light of the attorney-client privilege issues raised by some commenters, how do audit firms currently comply with requirements of PCAOB standards and Section 10A of the Exchange Act?*

Auditors rely on a company's legal counsel to provide the information that they need to evaluate information about potential NOCLAR within the parameters of Section 10A of the Exchange Act. We refer to the additional comments of the ABA.

- 2. How would the proposed amendments affect the privilege differently than current audit requirements?*

Under the proposed standard, the auditor would perform audit procedures to find NOCLAR and would be required to make additional inquiries and obtain and review related documentation to make an assessment as to whether there is a potential NOCLAR.

Currently, auditors remain alert through the audit for facts and circumstances that may indicate that there is NOCLAR that warrants additional consideration. Auditors also become aware of NOCLAR from client management, boards, and legal counsel. Auditors rely on a company's legal counsel to provide information regarding those potential instances of NOCLAR and any other potential litigation claims and assessments that meet the threshold for reporting and disclosure. Once that threshold is met, the auditor will obtain

information from legal counsel needed to comply with the audit standards and financial statement reporting requirements.

As the threshold for the proposed procedures is lower than the threshold under Section 10A of the Exchange Act, it could result in the auditor requesting documentation that is subject to attorney client privilege to actively search for potential NOCLAR beyond those that are identified by management, the board, and the company's legal counsel.

3. *Commenters and staff have observed that noncompliance with laws and regulations are typically identified by issuers through means (which are nonprivileged) such as systems designed to address violations of laws and regulations or company policy (e.g., ethics and compliance hotline). Are there other common areas of identification of noncompliance such as through privileged communications? Where privileged communications are the source for a company's knowledge of noncompliance, in what situations do companies disclose the noncompliance to third parties, including auditors, investors, regulators, and/or criminal authorities?*

No comment.

4. *In addition to commenters' concerns regarding the potential waiver of attorney-client privilege, how do the considerations above relate to the potential waiver of work-product protection? Do the proposed amendments affect work product differently?*

No comment.

Topic: Benefits and Costs of Proposal

Summary of Cost Considerations

The cost and feasibility of embarking on this proposal is unclear and ill-defined, other than it has been described as "substantial." No one has evaluated what the impact will be on audit quality and capital markets if auditing firms undertake the extreme measures called for in this proposal. The cost will fall heaviest on smaller companies trying to access capital markets. This proposal may also undermine audit quality – the stated goal itself – when auditors are asked to evaluate things outside the realm of financial reporting and internal controls. The time and resources of auditors are not unlimited.

The proposal does not include a proof of concept nor does it reference a feasibility study in which the PCAOB has analyzed how the scope of the proposal could be operationalized in practice. Even with additional skilled resources participating on an audit engagement, it is not clear how the auditor could comply with the excessively broad scope and predictive nature of the required conclusions.

The audit profession is facing a serious talent-replacement challenge due to shifts in demographics and a shrinking pool of students earning degrees in accounting. The PICPA has performed considerable research

on this topic and has issued an Insights report, *The CPA Pipeline: Crisis and Opportunity*, that we can make available to you. This shortage has been highlighted in numerous news reports over the past year, which includes reports of several entities unable to find an auditor and a company that had to disclose a material weakness in internal control due to its lack of accounting staff.

We believe the proposed changes to the PCAOB standards for NOCLAR represent a breathtaking expansion of audit responsibilities that would further exacerbate the talent pipeline challenges due to the following factors:

- a. Significant increases in the number of professionals involved in an audit, including attorneys and compliance experts knowledgeable in all areas of compliance, laws, and regulations, both domestic and international.
- b. Considerable retraining of current auditors.
- c. Revamping of audit methodologies.
- d. Revising college curriculum for auditors and the CPA Exam.

At the same time, the PCAOB proposal includes a note that the potential increase in legal liability on the audit firms is unknown and would simply force auditors to do more work. We believe that many auditors and small firms may choose to discontinue performing this work if the liability is unknown and the required competencies are being expanded beyond their training.

The Center for Audit Quality (CAQ) developed [an analysis of the proposed amendments and an analysis of the comment letters](#).² The CAQ refers to two comment letter respondents concerned about projected costs. The Audit Committee Council noted that if the proposed changes were to have the same impact on the scope of an audit that implementing Section 404 of The Sarbanes Oxley Act of 2002 (SOX) did, it would increase audit fees by \$9.1 billion annually. The U.S. Chamber of Commerce Center for Capital Markets Competitiveness predicted that the cost of this proposal would far exceed the cost of implementing SOX, and conservatively estimates that it would increase fees for public companies in excess of \$36 billion annually.

Note that these costs would not only stem from increases in the audit fee, but also in the amount of time that it would take for management and all legal and regulatory compliance teams to work with the auditors and to provide them with extensive information not previously provided. These costs would disproportionately hit smaller companies that may be unable to find or afford an auditor willing to perform these engagements. Given the significant increase in the amount of work to be performed, there is a real risk of missing financial reporting filing deadlines.

² Center for Audit Quality (CAQ) Comment Letter Analysis – NOCLAR - <https://www.thecaq.org/comment-letter-analysis-noclar>

1. *What do panelists or commenters perceive as the economic benefits and costs of the proposal, and how do they differ from the status quo, both quantitatively and qualitatively? Whenever possible, provide your responses separately by firm size (e.g., large, medium, small) and stakeholder (e.g., preparers).*

We refer to our summary of cost consideration regarding the potential costs, which we believe to be excessive.

2. *Please share any additional data or studies to clarify the economic impacts. Are panelists or commenters aware of additional data or studies on the current cost of unidentified noncompliance with laws and regulations on investors?*

The American Association of Certified Fraud Examiners maintains an annual report on the cost of occupational fraud. We know of no additional data or studies on the current cost of unidentified NOCLAR.

3. *What do panelists or commenters perceive as the impact of the proposal on small- and medium-size audit firms, and how have you quantified such impact?*

We believe that implementing this proposal would result in many small and medium-size audit firms leaving the public company audit space.

4. *What broader impacts have you determined of auditors' identification of noncompliance with laws and regulations that could reasonably have a material effect on the financial statements to the capital formation or, more broadly, macro socioeconomic environment? Are there data or studies that can help us estimate those impacts? For instance, is there evidence to suggest that capital costs would be lower if investors had greater confidence that auditors would identify noncompliance with laws and regulations that could reasonably have a material effect on the financial statements?*

As described in our cost considerations above, we believe that implementing this new proposal would result in significantly exacerbating the auditor pipeline challenges.

5. *To the extent panelists or commenters provide additional alternatives, are there data or studies that can help us estimate the benefits and costs of any of these alternatives?*

We recommend updating the risk assessment procedures to include additional inquiries regarding NOCLAR and retaining the current distinction between direct and indirect NOCLAR. The International Auditing and Assurance Standards Board (IAASB) has an exposure document, Proposed International Standard on Auditing 240 (revised), The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements and Propose Conforming and Consequential Amendments to Other ISAs, which proposes enhancements to the auditor's responsibilities on fraud in an audit of financial statements. We recommend that the PCAOB leverage the due process work performed by the IAASB. We also support additional staff guidance

regarding how practitioners can better leverage technology-assisted audit techniques to improve audit quality in this area. We do not believe that this alternative approach would be burdensome.

6. *In light of the discussion of costs and benefits, how do investors, issuers, and auditors view the justification of the proposal?*

We do not believe that the costs of implementing this new proposal is justified. See further comments in our summary of cost considerations above.

We appreciate your consideration of our comments and are available to discuss any of these comments with you at your convenience.

Sincerely,



Allison M. Henry, CPA, Vice President – Professional & Technical Standards