



March 18, 2024

By email: comments@pcaobus.org

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

Re: Proposing Release: 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 Office of the Secretary:

The Center for Audit Quality (CAQ) is a nonpartisan public policy organization serving as the voice of US public company auditors and matters related to the audits of public companies. The CAQ promotes high-quality performance by US public company auditors; convenes capital market stakeholders to advance the discussion of critical issues affecting audit quality, US public company reporting, and investor trust in the capital markets; and using independent research and analyses, champions policies and standards that bolster and support the effectiveness and responsiveness of US public company auditors and audits to dynamic market conditions. This letter represents the observations of the CAQ based upon feedback and discussions with certain of our member firms, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ supports the PCAOB's intention to modernize and strengthen auditing standards related to the auditor's consideration of a company's noncompliance with laws and regulations (NOCLAR), including fraud, as a way to strengthen auditing practices, be responsive to stakeholders' evolving needs and continuously improve audit quality. The auditing profession has been and remains committed to its role among the various stakeholders in the US financial reporting ecosystem and is supportive of enhancements to existing auditing standards in this area.

This comment letter is a supplement to the [letter](#) that we submitted on August 7, 2023. We continue to echo the comments and concerns raised in that comment letter. In this letter we provide the following:

- Data we have compiled and analysis we have completed subsequent to our August 7, 2023, comment letter;
- Alternatives to the proposed requirements that should form the basis for further outreach and consultation by the PCAOB; and



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- Observations from the March 6, 2024 virtual roundtable.

Additional data and analysis

CAQ NOCLAR Comment Letter Analysis

As of November 2023, the PCAOB received 139 comment letters in response to its NOCLAR proposal.

The NOCLAR proposal has drawn the attention of various stakeholder groups. Based on our analysis, we noted that commenters took the following positions:

- The majority of commenters, 109 comment letters (or approximately 78%), expressed opposition to the NOCLAR proposal. (29% of investor comment letters expressed opposition.)
- The minority of commenters, 18 comment letters (or approximately 13%), expressed support for the NOCLAR proposal. (57% of investor comment letters expressed support.)
- A smaller set of commenters, 12 comment letters (or approximately 9%), did not state a clear position. (14% of investor comment letters did not state a clear position.)

We believe there is strong stakeholder support for the goal of modernizing the auditing standards and continuing to enhance audit quality in order to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

In our analysis, we noted that much of the feedback from commenters highlighted the diversity of views from stakeholders and the need for reconciliation prior to finalizing an amended NOCLAR standard.

For additional details, we refer you to the full comment letter analysis, which can be found [here](#).

CAQ Institutional Investor Survey

Understanding how a broad range of investors perceives and utilizes financial and non-financial corporate information is crucial for promoting transparency, trust, and stability in financial markets. The CAQ encourages the PCAOB to supplement the work of the Investor Advisory Group by continuing to seek input from a broad range of investors to understand their needs and expectations when it comes to noncompliance with laws and regulations beyond noncompliance due to fraud.

Since 2022, the CAQ has partnered with KRC Research, a public opinion research consultancy, to conduct independent quantitative and qualitative field work involving a diverse group of investor community stakeholders. Between January 29th and 31st of 2024, KRC Research conducted a survey focused on noncompliance and fraud among 104 institutional investors with at least \$500 million in assets under management. Specifically, the survey requested input from institutional investors on their needs and expectations when it comes to NOCLAR (including fraud).



The results of this survey demonstrate, among other things, that (1) the views of investors vary regarding the sufficiency of the current corporate reporting landscape with respect to public company NOCLAR, and (2) to the extent there is a need to provide investors with additional decision-useful information regarding a company’s NOCLAR, this cannot be achieved through changes to auditing standards alone.

Only 13% of institutional investor respondents indicated that the information available on NOCLAR does not meet some or most of their needs, while 31% said they currently have access to most or all the information necessary to make an informed investment decision, with the remainder falling somewhere in the middle. Additionally, only 20% responded that the US corporate reporting system is not keeping pace with the NOCLAR/fraud environment and needs significant revisions to prevent and root out NOCLAR (including fraud). This generally aligns with survey results that showed 45% of investors believe that the current corporate reporting system can effectively prevent or identify NOCLAR (including fraud), but needs “some” updating.

For investors who do believe it is frequent that a company’s noncompliance (including fraud) goes undetected by stakeholders in the US corporate reporting ecosystem, the majority of respondents (83%) identified stakeholders other than auditors as most responsible to do more to detect noncompliance: 37% identified federal agencies and regulators, 32% identified public company management, and 14% identified audit committees as most responsible for better detection. This further supports the point raised in our prior comment letter that the interaction of the NOCLAR proposal with the existing accounting and disclosure standards and related regulations should be explored with the Financial Accounting Standards Board and the Securities and Exchange Commission.

For additional details, we refer you to the full results of our survey, which can be found [here](#).

Alternatives to the proposed requirements that should form the basis for further outreach and consultation

Existing AS 2405 predates many important developments in the auditing profession and in the financial reporting ecosystem more broadly (e.g., 10A, SOX). Discussions during the March 6th roundtable demonstrated that a misunderstanding may exist among constituents relative to what auditors do today with respect to NOCLAR, particularly with respect to NOCLAR that could have what is characterized in the existing auditing standards as having a more indirect effect on the financial statements.

Auditors’ responsibilities to detect NOCLAR

Notwithstanding the above, there is a fundamental principle underpinning existing AS 2405, as well as Section 10A and SEC requirements related to ICFR, that remains important. As described within the PCAOB’s NOCLAR proposal, existing AS 2405.05 describes the auditor’s responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts as the same as that for misstatements caused by error or fraud. As described in 15 U.S. Code Section 78j-1(a), auditors’ obligations around noncompliance are focused on



“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.”

Existing AS 2405.07 describes the auditor's responsibility with respect to detecting, considering the financial statement effects of, and reporting other illegal acts, which may, in particular circumstances, be regarded as having material but indirect effects on financial statements. AS 2405.07 describes that because of the characteristics of other illegal acts, an audit made in accordance with PCAOB auditing standards provides no assurance that other illegal acts will be detected – this is because the procedures performed in connection with an audit on indirect laws and regulations under existing standards are designed for a different objective and are far less extensive than those performed for laws and regulations with direct effects. **In our view, the distinction between these two types of illegal acts and the nature of the auditor’s responsibilities related to each, remain appropriate. The responsibility to design procedures to provide reasonable assurance with respect to the detection of NOCLAR having a direct and material effect on the determination of current period financial statement amounts continues to be an appropriate requirement for auditors and aligns with the requirements of Section 10A and other SEC requirements directed at management relating to ICFR. However, while we do not believe it should be the auditor’s responsibility to detect instances of NOCLAR outside of that population, we believe there are more procedures, as described further below, auditors could perform in relation to the risks arising from NOCLAR that is characterized today as having an indirect effect on the financial statements.**

Auditors’ responsibilities if they detect or otherwise become aware of potential NOCLAR

As is also described in the NOCLAR proposal, firms auditing public companies are required to comply with the illegal acts provisions of Section 10A of the Securities Exchange Act of 1934 as described above in relation to designing procedures related to detection of illegal acts that would have a direct and material effect on the determination of financial statement amounts. Section 10A(b)(1) also establishes further requirements if the auditor detects or otherwise becomes aware of information indicating that an illegal act “has or may have occurred,” including the auditor’s obligation to determine and consider the possible effect of the illegal act on the financial statements of the issuer including any contingent monetary effects, such as fines, penalties, and damages. Additionally, 10A(b)(1) requires the auditor, as soon as practicable, to inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such firm in the course of the audit, unless the illegal act is clearly inconsequential. These requirements apply to all illegal acts, regardless of whether the act has a direct or indirect effect and regardless of whether it is “perceived to have a material effect on the financial statements.” **We are supportive of updating existing auditing standards to incorporate requirements of the auditor that are currently described in Section 10A of the Securities Exchange Act of 1934.**

Potential updates to increase the likelihood that auditors become aware of potential NOCLAR that could have an indirect effect on the financial statements



Existing AS 2405.04 describes that “generally, the further removed an illegal act is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor is to become aware of the act or recognize its possible illegality.” However, there are procedures performed within the audit that might bring noncompliance with laws and regulations beyond those with a “direct” effect to that auditor’s attention. **We are supportive of updating the auditing standards to enhance the auditor’s focus on company NOCLAR (including enhancing the auditor’s focus on noncompliance that has more of an “indirect” effect on the financial statements) to increase the likelihood that auditors become aware of potential noncompliance that could have a material effect on the determination of financial statement amounts (e.g., a contingency should be recorded or disclosed based on the requirements of the applicable financial reporting framework).** However, any new requirements should allow the auditor to maintain a role that: preserves their independence by avoiding the perception that they are part of management’s control structure, aligns with their knowledge and skillsets, is based within the context of management’s requirements today, and aligns with the scope and objective of an audit. Fundamental to maintaining alignment with the objective of an audit is maintaining a risk-based approach to planning and performing an audit. **With respect to noncompliance, the auditor’s focus should be on considering how risks of noncompliance at the company being audited may affect risks of material misstatement on the determination of financial statement amounts.**

With that focus in mind, **we are supportive of codifying risk assessment procedures that auditors perform today and further strengthening them to increase the likelihood that auditors become aware of potential noncompliance that could have a material effect on the determination of financial statement amounts (e.g., a contingency should be recorded or disclosed based on the requirements of the applicable financial reporting framework) and appropriately respond.** This could include adding requirements related to:

- Understanding the processes and controls management has in place to identify instances of noncompliance and the outcome of those processes (e.g., relevant aspects of a company’s compliance programs);
- An increased focus on inquiries of management, audit committees, internal audit, legal counsel, compliance personnel, and others about potential noncompliance, supported by additional written representations; and
- Consideration of evidence of legal and regulatory concerns, such as inspection of regulatory correspondence.

The topical suggestions above can serve as a basis for continued outreach and consultation by the PCAOB regarding more specific requirements in these areas. We and the profession stand ready to engage in further dialogue regarding these and other potential risk assessment procedures that could be required of auditors to increase the likelihood that they become aware of potential noncompliance and appropriately respond.

While we support exploring these areas, addressing the concerns related to the scope and extent of auditors’ responsibilities cannot be achieved through isolated changes to the NOCLAR proposal given the interconnectedness of the areas in which the PCAOB has proposed amendments and the resulting



potential “downstream” impact to the proposal of any changes that are made. Comprehensive updates to the NOCLAR proposal are needed and, as such, re-proposal is important to allow for a full and transparent vetting of the cascading effect of any changes made. Given the limited comment re-opening period, we did not have time to work through these interconnected changes that would be necessary but, as noted above, we stand ready to engage in further dialogue with the PCAOB staff and Board.

Observations from March 6, 2024 virtual roundtable

The CAQ appreciates the PCAOB holding the roundtable and related public outreach as a mechanism to further explore this very important topic, and we appreciate having been given the opportunity to participate. We encourage the PCAOB to continue to engage in stakeholder outreach, particularly with investors and members of the academic community who indicated concerns with the NOCLAR proposal, as well as with audit committee members (given their key role in hiring, overseeing and compensating the external auditor), to obtain input on the NOCLAR proposal.

As reflected in the results of the independent institutional investor research and comment letter analysis referenced above and based on our observations from the roundtable, there is a wide range of views with respect to where enhancements are needed in the area of NOCLAR, as well as with respect to the proposed requirements. However, there was agreement from participants representing different stakeholder groups on some important topics. Specifically, it was clear that auditors are supportive of both codifying procedures they perform today as well as strengthening them. Additionally, there appeared to be reasonable alignment across stakeholder groups with the view that the auditor should be using the work of management as the starting point for their procedures around NOCLAR and should not be required to perform their own independent assessment. Similarly, there appeared to be alignment in the view that it would not be reasonable to expect that auditors would identify a complete population of laws and regulations to which a company is subject (as was similarly stated in the NOCLAR proposal).

Given the range of perspectives on current practice and the opportunities for enhancement through a revision to the standards, continued multi-stakeholder dialogue is needed so that all impacted stakeholders have clarity on objectives, expectations, and responsibilities. As an example, prior to the adoption of amended PCAOB AS 3101 in 2017, a concept release was issued prior to an exposure draft, and once exposed, the proposal was discussed by multiple categories of stakeholders at seven advisory group meetings, one public meeting, and one roundtable. Similarly, prior to the finalization of PCAOB Rules 3210 and 3211 in 2016, the Board issued a concept release, two proposals, and a supplemental request for comment in order to obtain stakeholder feedback. Ongoing dialogue will be critical to the development of a re-proposal and/or final standard with clearly articulated objectives, scope, and expectations of auditors. As noted above, future multi-stakeholder engagement should include a broader range of stakeholders and viewpoints, including commenters from the investor community who expressed opposition to the PCAOB’s NOCLAR proposal, as well as more members of the audit committee community.



Economic analysis

In our view, the PCAOB has not yet demonstrated that they have sufficiently studied the costs and benefits of, and the alternatives to, the proposed requirements. Further study and evaluation are needed.

The PCAOB's own guidance on economic analysis of regulations involves four main elements: (1) need for the rule, (2) the baseline for measuring the rule impacts, (3) alternatives considered, and (4) the economic impact of the rule (and alternatives), including benefits and costs. More specifically, according to the 2014 guidance, for any adopting release, the release should contain a complete economic analysis of the final standard, and the economic analysis should also address relevant comments received on the proposed standard. Additional guidance released in 2020 goes on to state that any economic analysis should be responsive to the financial reporting and auditing environments and carefully weigh the costs, benefits and potential unintended consequences.

The NOCLAR proposal states that “[a]uditors would likely need to expend considerable additional audit effort to identify relevant laws and regulations under the proposed standard” and that “the costs associated with the proposed amendments...may be substantial.”¹ However, the NOCLAR proposal does not provide or quantify the potential costs, or show that they would by necessity outweigh the benefits. Moreover, study of the benefits should not be based on the assumption or expectation that audits are capable of preventing NOCLAR or fraud, or completely eliminating costs incurred by companies as the result of illegal acts, which was a theme raised during the roundtable. Study of the benefits should identify and quantify the expected benefit of the auditor performing specific procedures (i.e., demonstrate the connection between the increased audit effort and the expected outcome of more timely disclosure of noncompliance and the perceived value of more timely disclosure). At a minimum, it would be helpful for any re-proposal and/or final standard to clearly explain how such proposal/final standard is expected to achieve the PCAOB's desired objectives and outcomes.

Based on the PCAOB's existing guidance, study of the costs should also quantify the baseline based on current auditor responsibilities for the identification, evaluation, and communication of noncompliance and firms' current practices. This study should contemplate and seek to quantitatively measure implementation costs of the proposed rule on auditors and companies and ongoing costs related to increased audit effort (including how such effort may or may not vary based on the size and complexity of the issuer). Such costs should be estimated based on the specific procedures an auditor would be expected to perform as a result of the proposed requirements that are beyond the current requirements, including how those procedures would be expected to vary based on management's processes, procedures and controls around noncompliance. During the roundtable, participants representing auditors suggested that the PCAOB consider whether the data and information they have access to via inspections can be leveraged in determining quantitative estimates of the costs. For example, it was

¹ Refer to release text page 81.



suggested that relevant information could be gathered by the PCAOB through a targeted inspection program in this area.

Additionally, because audit committees oversee the retention, oversight and fees of the external auditors, they represent another potential source of cost information. Given the PCAOB's extensive audit committee engagement and the awareness of and interest in the NOCLAR proposal by audit committee members as evidenced through the comment letter process, we encourage the PCAOB to seek data and information from this important stakeholder group to help inform a quantitative economic analysis.

Various academic studies are cited in the economic analysis section of the NOCLAR proposal and were discussed during the roundtable, seemingly for the purpose of demonstrating the investor harm that can result from company NOCLAR. However, the studies cited are focused on fraud, rather than NOCLAR (which encompasses a far broader universe than fraud), with different benefits.² Similarly, the points raised during Panel III (Economic Impacts) of the roundtable regarding the desired or expected benefits of the NOCLAR proposal were focused on the potential for auditors to have prevented, or earlier identified or communicated, instances of fraud that have occurred in the past. These observations highlight a concern raised in our prior comment letter regarding including fraud in the proposal's definition of NOCLAR. We continue to hold the view that there is a lack of clarity with respect to the linkage between proposed AS 2401 and proposed AS 2405 and how, in practice, an auditor would go about applying the two standards in combination to meet their responsibilities with respect to fraud. The academic studies and other assessments of the suggested benefits indicate that many if not all of the benefits could potentially be achieved by focusing on fraud specifically.

Need for re-proposal

The point was made multiple times during the roundtable that the specific words in the standard are important for consistent interpretation and application. We believe that the significant and substantial nature of the changes that are likely needed to the NOCLAR proposal to respond to the nature and extent of comments received, as reflected in the comments previously submitted to the PCAOB and additional points discussed above, warrants re-exposure. Our recommendation that the standard be re-proposed is not a strategy to delay any effective date (as was suggested during the roundtable). Rather, we believe that an additional investment of time is needed to ensure that the effects of any changes made, including any downstream effects, are fully understood and consistently interpreted, as well as to ensure that the purpose of the standard and expected changes to auditor behavior are clearly understood, that it is capable of being consistently implemented, and that it will ultimately benefit investors.

² Additionally, at least one of the studies included foundational data on fraud prior to the implementation of the Sarbanes-Oxley Act, thus not taking into account the significant reforms established under this landmark legislation.



The CAQ appreciates the opportunity to comment on the Proposing Release: Amendments to PCAOB Auditing Standards related to a Company’s Noncompliance with Laws and Regulations and Other Related Amendments, and we look forward to future engagement. As the Board continues to gather feedback from other interested parties, we would be pleased to discuss our comments or answer questions from the Board regarding the views expressed in this letter. Please address questions to Emily Lucas (elucas@thecaq.org) or Dennis McGowan (dmcgowan@thecaq.org).

Sincerely,

A handwritten signature in black ink that reads "Dennis McGowan".

Dennis McGowan, CPA
Vice President, Professional Practice
Center for Audit Quality

cc:

PCAOB

Erica Y. Williams, Chair
George R. Botic, Board member
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