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March 18, 2024

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Proposing Release – *Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations* (PCAOB Release No. 2023-003, June 6, 2023: PCAOB Rulemaking Docket Matter No. 051)

Via: comments@pcaobus.org

Dear Ms. Brown:

The Travelers Companies, Inc. ("Travelers") appreciates the opportunity to provide additional comments following the recent Roundtable hosted by the PCAOB on March 6th regarding Release No. 2023-003, PCAOB Rulemaking Docket Matter No. 051 with the above captioned title (the "proposal") as issued by the PCAOB on June 6, 2023.

Travelers provides a wide range of commercial and personal property and casualty insurance products and services to businesses, government units, associations, and individuals. A member of the S&P 500 and the Dow 30, Travelers is one of the oldest insurance organizations in the United States, dating back to 1853.

In response to the discussion at the Roundtable that I participated in, we have identified two follow-up comment topics that we believe are particularly important. Both are related to the need to have a risk-focused audit standard that provides practical but effective guidance to auditors in planning appropriate audit procedures. The two follow-up comment topics are:

- elimination of the distinction of noncompliance that has a direct versus indirect effect on a public company's financial statements; and

- the threshold to be used by the auditor in identifying laws and regulations relevant to the audit of a company's financial statements.

Distinction between Direct versus Indirect Effect on the Financial Statements

In our view, the proposal inappropriately abandons the distinction between direct versus indirect impact from illegal acts and adopts a new concept of non-compliance with laws and regulations (NOCLAR) while imposing for the first time an unconditional obligation on the auditor to plan and perform certain audit procedures.

The existing distinction between direct and indirect effects on the determination of financial statement amounts allows auditors to prioritize and manage resources with respect to the procedures that are applied in an audit to focus on those areas that would have a direct and material effect on financial statement amounts. While it is true that indirect laws and regulations can result in material misstatements of the financial statements, it is also true that direct laws and regulations have a higher likelihood of resulting in a material misstatement. Importantly, it is also true that the further removed an instance of non-compliance with laws and regulations is from events and transactions ordinarily reflected in the financial statements, the less likely it is that the auditor will have the expertise or legal judgment necessary to identify and make judgements with respect to non-compliance. Accordingly, this distinction and prioritization are important, particularly for industries that are highly regulated, such as the property and casualty insurance industry.

To give you some context of the volume of laws and regulations that an insurer must track, during 2023, we tracked more than 5,100 changes in general insurance laws, regulations, bulletins, and circular letters in the 50 states alone. This number does not include the laws that cover regulatory financial reporting and related capital requirements, or laws and regulations applicable in jurisdictions outside of the United States. There are also many other types of laws and regulations that we track that impact Human Resources/Employment, Tax, and SEC-related matters, among others. As a result, we believe it is critical that auditors continue to apply a risk-focused audit standard that is both practical and effective.

By extending the auditor's responsibilities to include laws and regulations with which noncompliance ***could*** have an ***indirect*** impact on the financial statements, the additional requirements described in the proposal would also extend the auditor's responsibilities well beyond providing reasonable assurance that a company's financial statements were prepared in accordance with U.S. GAAP and regarding the effectiveness of the company's internal control over financial reporting (ICFR). Such an expansion would be well-beyond the auditors' core experience and competencies and would add significantly to the direct and indirect costs of an audit, potentially distracting auditors from the core responsibilities of providing reasonable assurance and assessing ICFR.

Additionally, the proposal not only diverges significantly from other current PCAOB auditing guidance, including AS 2405: *Illegal Acts by Clients*, but is also disconnected from the underlying accounting guidance on which the accounting for, and disclosure of losses, fines, penalties, etc.

that may result from noncompliance with laws and regulations, is based, i.e., ASC Topic 450, *Contingencies*. Once a violation has been identified, the more relevant distinction is whether a resulting effect is remote, reasonably possible, or probable that the violation will result in a material impact (contingent liability) on the company's financial statements. This evaluation is made by management and can be independently evaluated by the auditor. Companies and auditors already have significant processes and procedures relating to the identification and evaluation of contingencies. It is not clear how the proposal would affect disclosures provided by public companies and whether users of financial statements would obtain any additional relevant information as the result of the proposal.

As an alternative to the proposal, we believe a more effective and efficient approach to auditing a company's risk of noncompliance with laws and regulations is to design audit procedures with respect to an evaluation of a company's fraud and compliance risk assessment as described in Principle 8 of the 2013 COSO Framework and the identification and testing of the company's internal controls related to compliance with laws and regulations. The audit procedures should be based on a risk-focused approach and consistent with how other risk areas are evaluated and tested during an audit. More importantly, such an approach should not involve the auditor duplicating management's efforts but should be designed with the goal of determining whether management's ICFR effectively prevents or detects material misstatements at the appropriate assertion level using the foundational testing approaches described in AS 13: *The Auditor's Responses to the Risks of Material Misstatement*:

- Inquiry,
- Observation,
- Examination or inspection of evidence,
- Re-performance of the control, and
- Computer-assisted audit technique (CAAT).

Threshold to be Used by the Auditor

The proposal uses the threshold "could reasonably have a material effect" as the standard for the auditor's identification of laws and regulations relevant to the audit of a company's financial statements. During the PCAOB Roundtable, it was suggested that the threshold should be "reasonably likely." We believe there are problems with both approaches.

In our view, the proposal's use of "could reasonably," and in particular "could," is overly broad, would be extremely difficult to implement, and could lead to divergence in practice by auditors[1]. Additionally, the identification of laws and regulations that "could" be material would increase the costs, result in delays and have other unintended negative consequences.

The threshold of "reasonably likely" is also problematic. This threshold was developed by the SEC in guiding management in the identification of matters that should be discussed under Management's Discussion & Analysis (MD&A) in Form 10-Q/K filings. The following is an excerpt from the relevant SEC staff guidance:

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[1]See *FASB Concept 8, Conceptual Framework for Financial Reporting*. Concept 8 initially changed the determination of materiality from "would" influence to "could" influence and was amended in 2018 to align with the Supreme Court definition reverting back to "would" influence.

TOPIC 9 - Management's Discussion and Analysis of Financial Position and Results of Operations (MD&A)

9100 MD&A OBJECTIVES

9220.11 There are two assessments that management must make where a trend, demand, commitment, event or uncertainty is known:

1. Is the known trend, demand, commitment event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
2. If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.

Note that "reasonably likely" is a lower threshold than "more likely than not" but a higher threshold than "remote". The concept of "reasonably likely" is used in the context of disclosure for MD&A purposes and is not intended to mirror the tests in ASC 450 established to determine when accrual is necessary, or when disclosure in the footnotes to the financial statements is required.[2]

The terminology "reasonably likely" does not exist in U.S. GAAP guidance. Instead, it is applicable to disclosure that is outside of the financial statements, subject to review by an auditor, but not subject to audit.

Both the U.S. GAAP and SEC guidance for preparation of the financial statements, on the other hand, are often based on the materiality standard established by the Supreme Court. Under Supreme Court precedent, including the decision in TSC Industries v. Northway[3] ("TSC Industries"), information is "material" if a **substantial likelihood** exists that (1) a reasonable investor **would** consider the information important in making a buy, sell, or hold investment decision or a voting decision or (2) disclosure of such information **would** have been viewed by a reasonable investor as having significantly altered the "total mix" of information available. We believe that any enhanced audit procedures regarding noncompliance with laws and regulations should be limited to laws and regulations with respect to which non-compliance would be material. This would be consistent with SEC Staff Accounting Bulletin No. 99 – Materiality:

[2] See SEC Division of Corporation Finance Financial Reporting Manual, available at https://www.sec.gov/files/cf-frm.pdf.
[3] See *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 439 (1976).

> Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is "material" if there is a **substantial likelihood** that a reasonable person **would** consider it important (*emphasis added*). In its Statement of Financial Accounting Concepts No. 2, the FASB stated the essence of the concept of materiality as follows:
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> The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.
>
> This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is - a **substantial likelihood** that the . . . fact **would** have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available (*emphasis added*)[4].

As a result, while we do not endorse the proposal, if the PCAOB nevertheless proceeds with a final PCAOB rule that eliminates the existing standard of "direct and material," we would recommend that the PCAOB incorporate by analogy the same threshold as that cited in TSC Industries. In this context, such a threshold would be "a **substantial likelihood** of noncompliance that **would** have a material effect on the financial statements." As a result, the auditors' procedures would then be designed to test the effectiveness of controls over financial reporting, in this case the identification of laws and regulations that impact the reporting and disclosures contained in the financial statements, aligned with the same objective as the preparation of financial statements, using terminology that exists in U.S. GAAP and SEC guidance that is well-defined and understood by both preparers and auditors of the financial statements.

Recommendations

The proposal presumes that the auditor should have a broader responsibility in identifying the applicable laws and regulations than is in the current standard. We believe there are problems with that premise, as it is management's responsibility to identify the laws and regulations with which it must comply and to put in place appropriate procedures and controls to fulfill its responsibility. It is the auditor's responsibility to assess the effectiveness and completeness of those processes and controls, not to duplicate them.

Auditors should not be placed in the position of performing management's responsibilities, which in this case would require skills outside of the auditor's training and professional credentials. The proposal would likely result in auditors engaging outside experts or hiring legal expertise to perform the additional procedures in many areas of highly specialized law and practice.

The proposal would effectively require auditors, or their specialists, to replicate management's efforts (at a level that is not likely to be at the same depth as management's) to obtain evidentiary matter, review internal documentation and communications, conduct legal research, and interview

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[4] See SEC *Staff Accounting Bulletin No. 99 (SAB 99) (August 12, 1999)*.

management. This approach treads very close to impairing the auditor's independence. We believe that imposing these responsibilities on auditors creates a high risk of misleading investors that the auditor has provided a greater level of assurance than they will actually provide, implies that the auditor has a shared responsibility in the preparation of the financial statements, which they do not, and significantly increases the cost and risk of delay of an audit. For these reasons, as well as the reasons discussed in our prior comment letter, we also believe that the proposal would diminish audit quality, not improve it. As a result, we respectfully recommend that the PCAOB withdraw the proposal.

If the PCAOB nevertheless decides to proceed with this project, given the importance of this audit standard, particularly as it affects highly regulated industries, such as insurance, we recommend that once the PCAOB completes its review of comments and consideration of the discussion from the Roundtables, it should re-propose any changes to the audit standards and that such re-proposal include a cost-benefit analysis of the re-proposal, including quantitative information where possible about the expected costs and benefits of the proposed changes. This is particularly important because we believe the costs of complying with the current proposal would be substantial and would exceed any benefit.

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We thank you for the opportunity to provide additional comments on the proposal and would be pleased to discuss our views with the PCAOB in any forum the PCAOB may choose. If you have any questions or would like to discuss our comments, please feel free to call me at (860) 277-0537.

Sincerely,

D. Keith Bell