Consumer Federation of America

August 7, 2023

Ms. Phoebe W. Brown
Secretary
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Release No. 2023-003; PCAOB Rulemaking Docket Matter No. 051 Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations

Dear Secretary Brown and Members of the Public Company Accounting Oversight Board (PCAOB):

I am writing on behalf of the Consumer Federation of America (CFA)[1] in strong support of the above-captioned proposal regarding amendments to PCAOB auditing standards related to an auditor's responsibility for considering a company's noncompliance with laws and regulations, including fraud, in an audit.[2] The current standard is out of date and has long been identified by investors as one in need of revision. By strengthening auditor standards for identifying, evaluating, and communicating a company's noncompliance with laws and regulations, the proposal should enhance audit quality, increase the likelihood that companies remedy any noncompliance in a timelier manner, and reduce the losses that investors suffer as a result of a company's noncompliance with laws and regulations. These proposed changes should bring auditor practices more in line with investor expectations.

Investors expect auditors to prepare and issue accurate, reliable, and complete reports that enable investors to make informed investment decisions about the companies they invest in. Furthermore, investors expect that auditors will act with objectivity and independence to identify and evaluate information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred, and to communicate information about potential noncompliance to company management and the audit committee in a timely manner. Investors expect that this process will reliably detect, remedy, and deter companies' noncompliance with laws and regulations.

[1] CFA is a non-profit association of more than 250 national, state, and local pro-consumer organizations. It was established in 1968 to advance the consumer interest through research, advocacy, and education.

[2] PCAOB Release No. 2023-003, PCAOB Rulemaking Docket Matter No. 051, Proposing Release: Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations And Other Related Amendments, June 6, 2023, https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket-051/pcaob-release-no.-2023-003---noclar.pdf?sfvrsn=fe43e8a_4

Unfortunately, current audit standards do not provide sufficient confidence to investors that their expectations are being met. Current PCAOB standards require the auditor to perform procedures designed to identify noncompliance with laws and regulations that have a direct effect on the financial statements; they do not require auditors to do the same for noncompliance with laws and regulations that have an indirect effect on the financial statements. As a result of this unjustifiable and unworkable distinction, auditors' required inquiries into noncompliance are limited and superficial and do not extend to instances of noncompliance that could reasonably result in a material effect on the financial statements as a result of penalties, fines, damages, and loss in shareholder value.

Unsurprisingly, under existing requirements, auditors often do not detect noncompliance with laws and regulations and investors end up paying the price.[3] For example, a recent study estimated that in normal times only one-third of corporate frauds are detected.[4] Combining fraud pervasiveness with existing estimates of the costs of detected and undetected fraud, the study's authors estimated that corporate fraud destroys 1.6% of equity value each year, equal to $830 billion in 2021.

The proposal would help to address these shortcomings in the current standards. First, the proposal would eliminate the unjustifiable and unworkable distinction that requires auditors to consider only the direct effect of noncompliance with laws and regulations on a company's financial statements and replace it with a standard that requires auditors to consider noncompliance with laws and regulations that could reasonably result in a material effect on the financial statements. The proposal would establish specific requirements for auditors to proactively identify and evaluate such laws and regulations.

These proposed changes would help to ensure that auditors' inquiries are no longer limited and superficial, which would improve auditors' detection of noncompliance with laws and regulations. Doing so would reduce the potential for noncompliance to result in material misstatements in a company's financial statements and the extent to which investors suffer losses as a result of noncompliance with laws and regulations. Importantly, the proposal also makes explicit that financial statement fraud is a type of noncompliance with laws and regulations, something auditors have struggled or conveniently refused to grasp.

Some have raised concern that this would require firms to identify "all the laws and regulations applicable to the company."[5] The proposal, however, does no such thing. As stated above, the standard would be limited to those matters that "could reasonably result in a material effect on the financial statements." We assume that competent and ethical auditors are already for the most part

---

[3] *See* Alexander Dyck, Adair Morse, and Luigi Zingales, Who Blows the Whistle on Corporate Fraud?, 65 Journal of Finance 2213 (2010) (finding that auditors have played a relatively minor role in detecting fraud, both before and after Enron. For example, before Enron, auditors accounted for 9.6% of frauds detected by external actors, and focused exclusively on frauds requiring financial restatements. After Enron, auditors accounted for 16.9% of cases, and their activity is spread across not only financial restatement cases, but also those cases not involving restatements.).

[4] Alexander Dyck, Adair Morse, and Luigi Zingales, How Pervasive Is Corporate Fraud?, Review of Accounting Studies 1 (2023).

[5] *See, e.g.* Letter from the Audit Committee Council, to the PCAOB, July 25, 2023, https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket-051/15_acc.pdf?sfvrsn=7eff78cf_4 ("To do this an auditor would first be required to identify all the laws and regulations applicable to the company. The largest of public companies are subject to a vast number of laws, regulations, etc. A large public company in a highly regulated industry can be subject to hundreds of new laws and regulations each year.").

considering matters that could have a material effect on the financial statements when conducting the required risk assessment. Failing to do so could raise serious concerns about the quality of the audit.

The proposal would also require the auditor to make specific inquiries of management, the audit committee, internal audit personnel, and others regarding noncompliance with laws and regulations. The proposal should explicitly add to the list any compliance officer or corporate official with similar authority. These proposed inquiries would help the auditor to identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, as well as the auditor's assessment of risks of material misstatement due to noncompliance.

In addition, the proposal would make it clear that the auditor is required to communicate to the appropriate level of management and the audit committee as soon as they are made aware that noncompliance with laws or regulations has or may have occurred. Requiring auditors to identify and communicate noncompliance to management and the audit committee as soon as they are made aware of any noncompliance should lead companies to cease and remedy any noncompliance in a timelier manner, which should reduce the extent to which investors suffer harm.

Moreover, evidence of noncompliance could prompt management to strengthen their internal control structures so as to more reliably deter noncompliance going forward. More timely identification and communication of noncompliance should also improve audit quality by decreasing the likelihood that financial statements are materially misstated due to the effects of noncompliance, which should further reduce investor losses and increase investor confidence in financial statements. As a result, these proposed changes should improve the detection, remediation, and deterrence of companies' noncompliance with laws and regulations, bringing auditor practices more in line with investor expectations.

While we strongly support the approach taken in the proposal, we recommend a number of modest changes that we believe are consistent with the purpose of the amendments.

First, we agree with the explicit requirement that auditors, in conducting a risk assessment, consider an expanded category of public disclosure, including sustainability reports and, in some cases, social media accounts of executive officers and, that in doing so, firms specifically look for inconsistencies and contradictions.

While inconsistent and contradictory statements may suggest concerns with the financial statements, they may also raise issues of noncompliance under the federal securities laws. In those circumstances, at a minimum, the inconsistencies and contradictions should be subjected to the same risk analysis as other instances of possible noncompliance and reported to the audit committee.

Second, we agree that auditors should be required to conduct additional procedures where they find evidence of material misstatements in documents containing "audited" financial statements. Audited financial statements are filed as part of the annual report on Form 10-K. The release gave as an example a key performance indicator (KPI) based upon metrics that had been intentionally inflated.

We believe that the requirement of additional procedures should be broadened. Where an auditor is aware that a KPI could be based upon falsified information, the obligation to conduct additional procedures should not be limited to documents containing “audited” financial statements. At a minimum, the requirement should apply to any periodic report or SEC filing that contained financial disclosure, including quarterly reports on Form 10-Q and earnings releases attached to current reports on Form 8-K. We also assume that evidence of misleading disclosure, wherever it occurred, would be a required part of the communication process between auditor and audit committee.

Finally, we believe that larger firms should have additional requirements with respect to the review of an issuer’s system of internal compliance. The proposal would require that auditors obtain an “understanding” of the system for identifying, evaluating, and investigating possible instances of noncompliance. The release suggests that in doing so, the firm may need to “test relevant controls” for compliance or examine reports produced by compliance specialists retained by the company. In doing so, firms will likely identify deficiencies in the system of compliance. We recommend that the standard explicitly require that these deficiencies be communicated to the audit committee.

We would also recommend that the standard go further for firms that audit more than 100 public company clients. Rather than simply requiring an “understanding” of the system of compliance, the standard should require an “assessment” of the system. Issuers may, for example, lack compliance officers.[6] Control testing may demonstrate inadequacies. Specialists may not have sufficient expertise or may lack independence from the company. The results of the assessment and any significant deficiencies in the system should be communicated to the audit committee.

In conclusion, this is a very positive effort. While we are disappointed that the proposal did not garner unanimous support by the Board, we very much appreciate that these divisions did not prevent the PCAOB from issuing a proposal that reflected a strong commitment to the PCAOB’s statutory mission of protecting investors and the public. For the foregoing reasons, we urge you to finalize this proposal without undue delay.

Respectfully submitted,

Micah Hauptman

Micah Hauptman
Director of Investor Protection

---

[6] Letter from Jennifer McWain, to the PCAOB, July 21, 2023, https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket-051/4_jm.pdf?sfvrsn=4fa0a810_4 (“The Department of Justice has issued substantial guidance that effective compliance programs include a compliance officer. Noting the presence of that officer and getting the perspective of that person whose job role is to be assessing and addressing compliance risks would improve the audit and make this standard stronger.”).