August 7, 2023

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

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

Dear Ms. Brown:

Thank you for the opportunity to provide comments on PCAOB Release No. 2023-003 (“the proposal”). This comment letter is being filed jointly by the Edison Electric Institute (EEI), the American Gas Association (AGA), and the National Association of Water Companies (NAWC), collectively “the Associations.”

EEI is the association that represents all U.S. investor-owned electric companies. Our members provide electricity for 220 million Americans and operate in all 50 states and the District of Columbia. As a whole, the electric power industry supports more than 7 million jobs in communities across the United States. In addition to our U.S. members, EEI has more than 60 international electric companies as International Members, and hundreds of industry suppliers and related organizations as Associate Members. Organized in 1933, EEI provides public policy leadership, strategic business intelligence, and essential conferences and forums. Our industry input is based on our extensive experience in developing and maintaining cutting-edge legal compliance programs.

Founded in 1918, AGA represents more than 200 local energy companies committed to the safe and reliable delivery of clean natural gas to more than 180 million Americans. AGA is an advocate for natural gas utility companies and their customers and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international natural gas companies, and industry associates. Today, natural gas meets more than one third of the United States’ energy needs.

NAWC member companies safeguard public health and promote environmental stewardship as they serve the water and wastewater needs of nearly 73 million Americans every day. NAWC members have an exceptional record of compliance with federal and state health and environmental regulations. Ensuring this high standard of quality requires extraordinary amounts of capital investment. The 10 largest NAWC member companies collectively invest nearly $3.7 billion annually to ensure their water infrastructure is well maintained and that safe and clean drinking water is available whenever needed.
Executive Summary

The industries in which the Associations operate are highly regulated, and our members support effective programs designed to assure compliance with laws and regulations. Management of our companies prioritizes a culture of compliance as stewards of the public trust in providing essential public services and infrastructure to support our communities and our economy. We understand that auditors for our industry regularly consider this culture as part of their evaluation of both our internal controls as well as our periodic public financial reports. Accordingly, we are strong advocates with a successful record of compliance with a host of laws and regulations.

As industries that successfully operate within a culture of compliance, we oppose the expansive nature of the proposal because it fails to give substantive consideration to the existing compliance function at public companies; the shared responsibility of boards of directors, audit committees, and executive management to assure that controls are appropriately designed and functioning; and the broadly effective execution of the accounting profession’s audit procedures. Accordingly, we urge the PCAOB, at a minimum, to make substantive modifications to address the numerous, significant shortcomings we have identified, including that the costs of this proposal far outweigh any potential benefits derived from it.

We disagree with the proposal for a number of specific reasons: it inappropriately expands the auditor’s role; fails to adhere to longstanding principles of materiality in financial reporting and auditing of reports by introducing a new standard (“could reasonably have a material effect”) that represents a broad, significant expansion of the current approach without evidence that the current approach is insufficient; inappropriately substitutes the auditor for activities that are the responsibility of management; implies that auditors should rely on outside counsel representations beyond that which is appropriate; and fails to demonstrate that the purported benefits of the proposal justify the costs or that there is even a material issue that needs to be addressed. We discuss each of these significant shortcomings in detail below.

While we cannot support the proposal in its current form, we welcome the opportunity to engage with the PCAOB and its staff to address the concerns we have raised.

Inappropriate Expansion of the Auditor’s Responsibilities

The proposal inappropriately expands the auditor’s responsibilities in an audit of the financial statements. Where a regulatory or other legal regime could lead to material financial exposure for noncompliance, the proposal significantly increases the auditor’s review of the compliance function with respect to that regulatory or legal regime. There are already established processes which we believe are sufficient for auditors to establish if a contingency exists, leveraging management’s own controls and procedures. It is unnecessary to institute an expansive, new process that would require auditors to go beyond assessing whether there is a contingency or disclosure issue under existing generally accepted accounting principles.
For utilities, the list of relevant regulatory regimes within scope could include not just the obvious air/water/ground and other environmental issues, but also compliance with Federal and one or more state rate regimes, nuclear regulatory requirements, securities law requirements, and consumer billing, collection and privacy requirements. For some utilities, safety regulations encompass nearly the entirety of their operations. In fact, we have identified 20+ regulatory regimes relevant to utilities that could potentially be in scope under the proposal and could require an auditor to audit nearly the entirety of the company’s operations.

The current audit approach permits consideration of management representations, among other evidence, with respect to compliance with laws and regulations, both from a company’s internal legal counsel and executive officers. The proposal supposes without evidence that this longstanding and proven approach is insufficient, despite the fact that company management designs and manages virtually all compliance programs under the oversight of the board of directors. Any benefit to duplicating their expertise would be, for the vast majority of companies, costly, immaterial and irrelevant, and there is no evidence that the representations under the current audit approach are flawed in a significant manner. More broadly, the proposal could require auditors to review otherwise privileged information (a much more expansive scope of laws/regulations, which is not necessary to meet the objectives of a financial statement audit), thereby creating significant complexities in managing the privilege in most jurisdictions.

The auditor would be required to understand management’s processes “related to, among other things, identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements” (emphasis added). The term “reasonably have a material effect” is not defined and is not otherwise part of the consideration of materiality. This shortcoming makes this concept too open-ended and invites significantly increasing the cost of audits along with the potential diversion of the auditor’s focus from other procedures that are consistent with the primary function of the audit.

The proposal also appears to require an audit of the compliance program for each such regime, regardless of the remoteness of potential materiality. Thus, it dramatically constrains the auditor’s ability to rely on evidence provided by the company, whether by its executive officers or its internal legal counsel, and likely would require the auditor either to employ legal specialists or create and develop this capability, which most audit firms presently lack in such magnitude.

As a result, the auditor will have to engage substantial support from numerous specialists – individuals with expertise in the wide variety of disciplines covered by such a requirement. In fact, given the diversity of the 20+ substantive areas that we have identified for utilities, it might require at least 20+ specialists, and some areas would require several as the topic is so broad, e.g., nuclear regulation, pipeline safety, and water quality/public health. As discussed below, the

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1 One issue with this wording is that it confuses “potential” with “probability.” As an illustration, an airliner “could reasonably” crash; a ship “could reasonably” sink. As drafted, the proposal would necessitate a review of both airliner and ship safety compliance programs, even though the events are highly remote, if even a single safety violation was identified. For the approach contained in the proposal to be even remotely reasonable, it would need to clearly focus on probable events, not potential events.
substantial costs resulting from this work likely would duplicate companies’ existing costs associated with their own compliance activities and ultimately would be borne by investors and customers.

We believe investors are best served by focusing each of the key stakeholders in the financial reporting process on their specific, important responsibilities – management’s responsibility for internal controls and fair presentation of financial statements and disclosures in accordance with generally accepted accounting principles; the board of directors’ (including the audit committee’s) oversight of management as stewards representing investors; and the public accounting firm as an auditor examining management’s reports and the controls over their preparation. Blurring these distinctions by having auditors encroach on the role of management would interject inefficiencies that would interfere with the timely preparation of accurate reports and distract from the auditor’s independence, objectivity, and focus in examining those reports.

**Failure to Respect Longstanding Principles of Materiality**

The proposal fails to respect the longstanding role of materiality in financial reporting and auditing and would preclude auditors from applying a risk-based approach. Where any noncompliance is found – even if not material – the proposal significantly expands what the auditor must do by requiring an audit of compliance in the relevant area and any adjacent programs, not just of the compliance program.

There is no limitation for materiality on the proposed requirement for the auditor to report all noncompliance. One example cited in the proposal is illustrative (emphasis added): “[I]f an auditor learned that a company filed a Form 10-K that contained inaccurate data or failed to include required information, the auditor would have to address this noncompliance without regard to the intent of the issuer or the materiality of such disclosure to the financial statements.”

The proposal contains a number of internal inconsistencies between the proposed obligation of auditors and the consideration of materiality under the longstanding, well-established definition of materiality and its application in financial reporting. In this regard, the proposal’s language is internally contradictory. On the one hand, it states, “The objective of the proposed standard instead would focus the auditor’s attention on any laws or regulations with which the auditor determined noncompliance could reasonably have a material effect on the financial statements, which includes but is not limited to those that have a direct and material effect on the financial statements.” By contrast, the proposal later states, “We believe that the proposed standard appropriately focuses the auditor’s attention on laws and regulations that could have a material effect on the financial statements.” (Emphasis added.)
Any revisions to auditing standards should respect the historical role of materiality\(^2\) in preparing and examining financial reports rather than introduce new, nebulous terminology that would confuse, rather than clarify, the standards for their preparation and audit. The internal inconsistencies in the proposal with respect to materiality also should be resolved, and any final rules should be consistent with the existing, well-established definition of materiality and its application in financial reporting.

**Inappropriate Subordination of Aspects of Management’s Responsibilities**

The proposal would inappropriately substitute the work and judgment of the auditor for certain fundamental aspects of management’s role and responsibility. It would inappropriately require the auditor to perform its own independent analysis and identification of compliance with laws and regulations rather than auditing management’s execution of these responsibilities.

The misplaced substitution of the auditor’s conclusions for those of management encroaches on the responsibility of management to prepare financial statements and disclosures and may inappropriately pressure management to subvert its judgment to that of the audit firm, further complicating already complex auditor independence analysis\(^3\) with the unintended consequence that management may be less invested in its responsibilities.

Further, the proposal would substitute the auditor for the role of management in making communications to the audit committee based on the flawed logic that investors will benefit because the auditors identify what the company’s controls should have identified. The proposal’s solution for supposed information asymmetry between the auditor and the audit committee would require communications from the auditor to the audit committee regardless of what management has communicated.

Instead of adopting new rules that misplace incentives, company management should be incentivized to maintain and improve controls as part of the execution of their own fundamental responsibilities. Management self-reporting on a timely basis is likely to be enhanced more by continuing to focus the auditor’s procedures on those communications that management has made. The current regime provides for the auditor to communicate on its own initiative if management refuses to do so – this focus on each stakeholder’s important role provides the appropriate incentives by continuing to place the primary burden of communication, both with the audit committee and investors in public reports, on management.

\(^2\) Preparers and users of financial statements, as well as the SEC, courts, and others, have for decades applied the Supreme Court’s guidance in *TSC Industries vs. Northway*, *Basic vs. Levinson* and their progeny. While the SEC has reminded registrants that there can be both “quantitative” materiality as well as “qualitative” materiality, both fall within the analytical framework of these cases. Yet the PCAOB in its proposal does not apply these concepts, regardless of what the release says. In particular, it imposes reviews that could be far below the threshold of *TSC Industries vs. Northway* based upon events that could be far below the probability threshold of *Basic vs. Levinson*.

\(^3\) At some point an auditor’s review and critique of complex compliance programs, and a registrant’s designing and managing its compliance programs in a manner designed to gain auditor approval undermines auditor independence. We believe the proposal crosses that point.
Flawed Reliance on Outside Counsel Representations

The proposed limitations on relying on management representations, including presumably representations by internal counsel, suggest an expectation that auditors will rely more heavily on outside counsel representations. However, outside counsel does not, and cannot, express an opinion on the effectiveness of compliance programs or their design.

Currently, outside counsel does not make any representations regarding the financial statements or compliance programs of their clients. Pursuant to the well-accepted accord between the AICPA and the American Bar Association, the primary role of outside counsel in connection with financial statement audits is to identify certain known disputes with respect to which they have provided legal advice and to describe the objective status of those disputes. This narrow role is driven by the need to preserve the attorney-client privilege.

Excessive Costs are not Justified by Purported Benefits

Economic Analysis assertions included in the proposal do not support the need for an expansive new rule of this nature. The evidence used to support the proposal is limited, unconvincing, and misguided, and the costs of its provisions far outweigh any purported benefit.

Information from PCAOB inspections does not support the need for expansive new rules. Those inspection results did not reveal any deficiencies in existing rules. Rather, they revealed diversity in the procedures that various auditors applied (without evaluating whether that diversity was appropriate or inappropriate based on facts and circumstances) or, in some cases, the auditor’s failure to follow existing rules. Neither of these circumstances indicate shortcomings in the existing audit rules that validate such an expansive change as that contained in the proposal.

Fundamentally, a company’s own internal controls should be the primary means by which noncompliance with laws or regulations is either prevented or detected. The fact that auditors play a limited role in detecting noncompliance, also cited in support of the proposal, is not necessarily indicative of a problem. The proposal cites only a handful of companies that had significant issues relative to the 6,000+ registrants subject to audit by firms under PCAOB jurisdiction.

Misplaced investor expectations that the auditors should be the primary watchdog over noncompliance reflect misunderstanding of the role and responsibilities of the auditor and the nature of an integrated audit. The auditor’s responsibility is to examine and report on the financial statements and notes prepared by management as well as to evaluate internal controls over financial reporting, not to establish procedures for assuring compliance with laws and regulations or to detect noncompliance with laws and regulations that do not directly affect the
financial statements. Investor education, not excessive new rules, is the more focused solution for any such misconceptions.

The proposal also cites decline in stock value due to “reputational loss” as another supporting reason, implying that its provisions would eliminate or reduce such losses. However, declines in stock value would occur for any material noncompliance, regardless of when such noncompliance is disclosed, either as required by management or as the result of an audit examination. The proposal would not eliminate such losses, and thus the erroneous implication that it would does not support the proposed changes.

The proposal asserts that imposing broad new requirements on auditors would address alleged shortcomings in auditor incentives with regard to noncompliance with laws and regulations. This presumption fails to take into account the professional responsibility of certified public accountants and actually impugns the integrity of the profession overall. The proposed new requirements would not increase the existing incentives of accounting firms for preserving their professional reputation and avoiding fines, penalties, and other discipline (that already exist for a failed audit) and ignores the broadly recognized integrity of the profession.

If the proposal is finalized as currently drafted, we would expect it to increase the cost of utility audits significantly, perhaps more significantly than the incremental cost of a Sarbanes-Oxley Section 404 audit, which Congress, the SEC, and the audit firms severely underestimated at the time of implementation. For heavily-regulated companies – utilities, financial institutions, healthcare providers – we are aware of estimates that the proposal’s requirements could double the cost of the audit function with no corresponding benefits. These costs would be both direct and indirect.

Direct impacts on the public accounting industry would include the broader scope of audits and the addition of a substantial number of new subject-matter experts in disciplines other than accounting and auditing. Indirect cost increases are likely to result if a greater number of accounting firms are not able to comply with the new audit requirements, resulting in fewer firms capable of such extensive work and limitations on engaging firms due to independence rules. The absence of a demonstrated need for such expansive new requirements, coupled with excessive costs, fails to justify this burden on companies, auditors, and ultimately the investment community and customers.

**Conclusion**

As highly regulated companies in industries with key public service responsibilities, our members consistently support effective programs to assure compliance with laws and regulations. This is part and parcel of our ongoing operations as well as the culture of our members’ organizations.
We believe that the current audit regime related to noncompliance with laws and regulations is effective and sufficient in identifying and addressing the accounting and disclosure implications of any such matters that are material. We strongly believe the proposal fails to provide any incremental benefits to the investment community, unnecessarily upends longstanding principles of financial reporting and the relationship between companies and auditors, and would therefore unnecessarily impose excessive new costs (ultimately borne by investors and customers) with no justification. We therefore cannot support the proposal.

As noted at the beginning of this letter, we welcome the opportunity to discuss our comments. We believe that active engagement with all relevant stakeholders is necessary in order to identify underlying issues and problems deemed necessary to be addressed, identify cost-effective solutions that would actually be effective in addressing those issues, and develop proposed standards that could be implemented in a way that respects the important underpinnings of the public company reporting system and the roles of its participants. We are available to discuss any questions on our recommendations at the Board’s convenience.

Respectfully submitted,

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