August 7, 2023
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.

Support for the PCAOB Modernizing the Auditing Standards

The CAQ appreciates the opportunity to share our views and provide input on the Public Company Accounting Oversight Board's (PCAOB or the Board) proposed *Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments* (referenced herein as proposed AS 2405, the proposing release, the proposed standards or the proposal). We and our member firms are committed to promoting audit quality and support the Board's intention, as stated within the proposing release, "…to modernize and strengthen auditing standards related to the auditor's consideration of a company's noncompliance with laws and regulations, including fraud, that has or may have occurred by improving the auditor's identification, evaluation, and communication requirements. [FN omitted]"[1] as a way to strengthen auditing practices and continuously improve audit quality. We believe that any project to modernize the auditing standards should be focused on enhancing audit quality and the benefit of an independent audit, while making it clear what an auditor is expected

[1] Refer to release text, Page 20.

CENTER FOR AUDIT QUALITY
555 13th Street NW, Ste 425 E
Washington, DC 20004

(202) 609-8120
www.thecaq.org

to do in the context of a financial statement audit. In this vein, while we support the general concept of modernizing the PCAOB's auditing standards, we have concerns about the proposal.

The proposed standards expand the auditor's responsibilities with respect to noncompliance with laws and regulations ("NOCLAR") and transform the auditor's role from one of providing reasonable assurance over the historical financial statements to one of performing procedures consistent with the objective of a compliance audit or forensics investigation. The focus on a much larger population of laws and regulations, the requirement for the auditor to design procedures to identify whether information exists about NOCLAR, and the expansive procedures that would be required of auditors to follow up on potential NOCLAR, including multiple required discussions with the audit committee, have the potential to take the auditor's and the audit committee's time away from focusing on evaluating matters that are more directly related to the goal of reliable financial reporting. As such, as described in more detail below, we are concerned that the amendments would result in requirements that may not be practical or achievable. Additionally, we believe that the proposal would not yield the results intended by the Board and that the cost to all participants in the ecosystem would outweigh any benefits.

The proposing release makes multiple references to the "well-established responsibility" of the auditor to "plan and perform the audit to obtain *reasonable assurance that the company's financial statements are free of material misstatement*, whether due to error or fraud."[2] (*emphasis added*) We do not believe the amended standards, as proposed, are sufficiently aligned with this responsibility nor with the objective of a financial statement audit. The proposal could be read as suggesting auditors have responsibilities to address noncompliance with laws and regulations that go well beyond management's own responsibilities and beyond that which could reasonably have current financial reporting implications. We share the views of Board Member Ho, as expressed in her statement on the proposal, in which she noted – "This expansion could cause considerable confusion on the appropriate role of auditors, undermine the time-tested accountability framework, and reduce the resilience of the already highly concentrated audit marketplace. Ultimately, this could undermine trust in our capital markets, to the detriment of investors."[3]

Moreover, we share the broader concerns expressed by Board Member DesParte in his statement on the proposal, in which he remarked that – "Stepping back, this project is one of 14 on our ambitious standard-setting agenda. Each of the projects is significant. As we proceed one-by-one, I am increasingly concerned we are establishing new auditor obligations and incrementally imposing new auditor responsibilities in ways that will significantly expand the scope and cost of audits, and fundamentally alter the role of auditors without a full and transparent vetting of the implications, including a comprehensive understanding of the overall cost-benefit ramifications."[4]

Overall Recommendations

Auditors support enhancing responsibilities with respect to NOCLAR

---

[2] Refer to release text Page 4 and Page 20.
[3] Refer to Statement on Proposal to Amend PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments made by Christina Ho on June 6, 2023.
[4] Refer to Statement on Proposal to Amend PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments made by Duane DesParte on June 6, 2023.

The auditing profession has been and remains committed to its role among the various stakeholders in the US financial reporting ecosystem, and shares with the PCAOB the common goal of fostering a strong and effective system for public company audits through establishing high quality auditing standards *that focus auditors on areas that are important and could give rise to a material misstatement of the financial statements being audited*.

Auditors are supportive of enhancements to existing AS 2405, but believe that updates need to be principles based and allow the auditor to take a risk-based approach. With this premise in mind, we have developed recommendations for where existing AS 2405 could be enhanced. These could be further considered by the Board and its stakeholders to determine whether they would be appropriate in the context of a financial statement audit.

- Auditors may be able to enhance their focus on how a company's NOCLAR could result in a material misstatement of the current period financial statements. Specifically, auditors may be able to perform the following:
    - As part of obtaining an understanding of industry, regulatory and other factors relevant to the company, auditors may be able to enhance their focus on understanding the laws and regulations to which the company is subject with which compliance is fundamental to its business model, and the potential impact of NOCLAR on the current period financial statements. This could include understanding which laws and regulations management has identified as potentially having an impact on the current period financial statements.
    - Enhance their focus on reading publicly available information about the company that may inform the auditor's risk assessment with respect to the risk of material misstatement of the current period financial statements resulting from NOCLAR, including NOCLAR arising from indirect laws and regulations with which compliance is fundamental to the company's business model.
    - As part of obtaining an understanding of the risk assessment process performed by the company, obtain an understanding of the compliance function of the company being audited *in the context of the potential impact on the current period financial statements and financial reporting process*. This could include understanding management's processes related to identifying laws and regulations to which the company is subject and management's process for preventing, identifying, investigating, evaluating (including evaluating potential accounting and disclosure implications), communicating, and remediating instances of NOCLAR. This could also include understanding their processes related to receiving and responding to tips and complaints from internal and external parties regarding NOCLAR. Auditors may be able to use this understanding to inform their risk assessment with respect to the risk of material misstatement of the current period financial statements resulting from NOCLAR.
    - As part of conducting a discussion among engagement team members regarding risks of material misstatement, enhance their focus on how the company's NOCLAR could result in a risk of material misstatement of the current period financial statements.
- Auditors may be able to do more to become aware of instances of NOCLAR that could result in a material misstatement of the current period financial statements, specifically:

- Expand on the currently required inquiries of management and the audit committee regarding NOCLAR, by making specific inquiries of internal audit, and others within the company (as deemed appropriate) regarding NOCLAR that could have a material effect on the current period financial statements; and can evaluate those responses. This could include performing inquiries of compliance officers or others within the compliance function.
- Inspect correspondence, if any, with licensing and regulatory authorities that govern those laws and regulations where compliance is fundamental to its business model.

Further study and evaluation are needed

Given the complicated and significant questions that have been raised related to the proposal, including by the dissenting board members, it is critical that the appropriate time and attention be spent on these matters prior to the finalization of the standards. We have endeavored to provide directional feedback and high-level recommendations within this letter, but we believe further engagement with stakeholders is needed to understand the implications of the proposal and whether it will meet the Board's objectives. The questions raised should be explored with all relevant stakeholders in the financial reporting ecosystem, including issuers and broker-dealers, audit committee members, auditors, lawyers, compliance professionals and investors from various groups and backgrounds. The interaction of the proposal with the existing accounting and disclosure standards and related regulations should also be explored with the FASB and the SEC. As part of this, we believe it is important that consideration be given to whether there are certain types of entities to which, based on their nature, the requirements of the proposed standard should not be applicable.[5] Furthermore, public roundtables and field testing will be useful and insightful in determining whether investor expectations, as reflected in the 2017 IAG Working Group Recommendations, are capable of being met given the role and skillset of auditors, and to the extent they are, whether the proposal will meet such expectations at an acceptable cost to all.[6] The CAQ stands ready to assist the PCAOB as appropriate, for example by convening stakeholders and providing further input to advance the auditor's role.

Key Observations

Our key observations on the proposal fall in the following five categories:

1. **Fundamental shift in the objectives of an audit:** The requirements proposed in the standards represent a fundamental shift in the auditor's objectives in planning and performing the audit. The proposed standard puts auditors in the position of performing procedures consistent with the objective of a compliance audit or forensic investigation. We recommend the Board look to the rulemaking history of Section 10A of the Securities Exchange Act ("Section 10A"),[7] as well as

[5] For example, the PCAOB determined that the requirement to determine and communicate CAMs should not be applicable to certain PCAOB audits when adopting AS 3101.
[6] Refer to the IAG's 2017 Report from the Working Group on Auditor's Consideration of a Client's Noncompliance with Laws and Regulations (NOCLAR), at https://pcaobus.org/News/Events/Documents/10242017-IAG-meeting/WG-slides-NOCLAR.pdf.
[7] See Section 10A of the Securities Exchange Act, Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, § 301 (Dec. 22, 1995), referenced herein as "Section 10A."

the rulemaking history of PCAOB Auditing Standard No. 2 *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* ("AS 2"), and the later need for PCAOB Auditing Standard No. 5 *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("AS 5," AS 2201 as reorganized), when finalizing the proposed standard.

2. **Scope of the proposal:** The securities laws and their implementing regulations do not require a public company's management to identify all laws and regulations to which the public company is subject, and yet this proposal appears to essentially require auditors to do so.[8] Our concern with the lack of clarity related to the "threshold" auditors would use to identify laws and regulations on which to focus their procedures is at the heart of our concerns with the proposed standards. Clarifying the threshold of which laws and regulations an auditor would need to focus on, and how this would relate to the risk assessment the auditor performs with respect to the historical financial statements being audited, would improve the operability of the proposed standard.

3. **Auditors are not lawyers or forensic specialists:** Broadening the scope of the laws and regulations for which the auditor must consider whether non-compliance "could reasonably" have a material impact on the financial statements would require a deep level of legal and regulatory subject matter expertise and interpretation, which does not fall within the core competencies of financial statement auditors and could be viewed as the auditor engaging in the unauthorized practice of law. The proposed standards significantly expand auditors' need for expertise from significant numbers of lawyers, regulatory experts, fraud experts, and other specialists.

4. **Role of auditor versus role of management:** A long-established accountability framework exists, whereby management prepares and discloses financial and other information; auditors obtain reasonable assurance about whether the financial information is prepared in accordance with a financial reporting framework, in all material respects; and regulators provide oversight of the public companies and auditors. The proposal essentially transforms the auditor's role into a responsibility to monitor an entity's compliance with evolving laws and regulations, which is, at a minimum, a compliance function and, potentially, a management function. Such a transformation would come at the detriment of the auditor's core responsibilities of performing an independent assessment of the financial statements prepared by management.

5. **Costs and benefits of NOCLAR proposal require further study:** The costs and benefits of the NOCLAR proposal have not been adequately studied. The proposal does not quantify the substantial costs that could be incurred as a result of the proposed standards, nor does it provide evidence that benefits will be achieved.

Our detailed comments on these observations are reflected below.

---

[8] While there is no such requirement, based on our members' experience, the vast majority of public companies do in fact have in place extensive compliance functions. Even then, a comprehensive listing of every single law or regulation to which the company is subject does not typically exist and would likely be out of date as soon as it was compiled, and compiling such a list does not seem like a meaningful or efficient exercise.

CAQ

Fundamental shift in the scope and objectives of an audit

The proposed requirements represent a fundamental shift in the scope of the audit and of the auditor's objectives in planning and performing the audit. The proposed standard puts auditors in the position of performing procedures consistent with the objective of a compliance audit or forensic investigation and would require a deep level of legal and regulatory subject matter expertise and interpretation, which does not fall within the core competencies of financial statement auditors, and could be viewed as the auditor engaging in the unauthorized practice of law. The proposed requirements would result in an audit objective that is substantially different than providing reasonable assurance that the company's historical financial statements are free of material misstatement, whether due to fraud or error. Investors are certainly harmed when companies incur significant penalties, fines, or loss of business opportunities as a result of NOCLAR. However, the suite of procedures an auditor can effectively perform in a financial statement audit is not the appropriate tool to catch noncompliance with laws and regulations sooner or detect those that do not result in material misstatements of the financial statements being audited. Moreover, with respect to penalties and fines that arise from operating businesses, the accounting standards (specifically, ASC Topic 450, *Contingencies* ("ASC 450")) have been promulgated with an eye toward providing investors adequate transparency at an appropriate time such that the likelihood of such material fines or penalties becomes reasonably possible.

Overview of existing requirements

Currently, AS 2405, *Illegal Acts by Clients*, which operates in conjunction with the illegal acts provisions of Section 10A, prescribes the nature and extent of the consideration the auditor should give to the possibility of illegal acts by an audit client in an audit of financial statements. Paragraphs .05 and .06 of existing AS 2405 provide context and explanation as to *why* the existing auditing standards recognize the limitations on the auditor's ability and responsibility to identify and respond to illegal acts by clients.[9]

[9] Refer to AS 2405 -
.05 The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts. However, the auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statements assertions rather than from the perspective of legality per se. 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 is the same as that for misstatements caused by error or fraud as described in AS 1001, Responsibilities and Functions of the Independent Auditor.
.06 Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects, and their financial statement effect is indirect. An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. For example, securities may be purchased or sold based on inside information. While the direct effects of the purchase or sale may be recorded appropriately, their indirect effect, the possible contingent liability for violating securities laws, may not be appropriately disclosed. Even when violations of such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he is informed by the client, or there is evidence of a governmental agency investigation

While we understand that the Board's intention in excluding such language from the proposed standard is to focus on the auditor's affirmative responsibilities, its exclusion does not make those limitations any less real.[10] Appropriate consideration of those limitations, and the benefits and costs of greater auditor involvement, has been a key component in the history of rulemaking on the topic of NOCLAR.

Rulemaking history of Section 10A

As described within the proposal, "Section 10A(a)(1) requires that issuer audits include '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.' Section 10A(b)(1) establishes further requirements if the auditor detects or otherwise becomes aware of information indicating that an illegal act 'has or may have occurred.' 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.'"[11]

Section 10A was crafted through significant consideration and debate through congressional hearings and other forums. Its legislative background spanned nearly a decade and the final version of Section 10A differs vastly from its original form due to considerable criticism from many different stakeholders. More specifically, the origins of Section 10A date to a bill that was introduced in 1986 in response to the savings and loan crisis. The bill was "designed to both require and enable independent auditors to detect and disclose illegal and fraudulent activities at publicly held corporations," and would have required an auditor to conduct every audit in accordance with "procedures that reasonably ensure the detection and reporting of any illegal or irregular activity by any director, officer, employee or agent of, or other person associated with, the entity being audited or examined" and report such activity directly to the SEC.[12] The "illegal and irregular activity" that the auditor was required to report was broadly defined to include any law violation and any "intentional" misstatement of a company's books and records. The then-current SEC Chairman's criticism of the bill included, among other things, that it "would change the role of the independent auditor" such that it "…seems to shift fraud detection accountability from corporate management to the independent auditor." Commenters pointed out that the bill's definitions of "illegal and irregular activity" "…would require auditor judgments on matters that they have neither the training nor the experience to make." The then-current Comptroller General pointed out that by failing to limit "illegal" or "irregular" acts only to those material to the financial statements, the bill essentially required auditors to "ferret out" all fraud and illegal activity, regardless of how trivial.

During the next few years, several more versions of the bill were proposed, although the features that prompted criticism remained. The 1990 proposal required that the audit include procedures to provide "reasonable assurance of detecting illegal acts that would have a material impact on the issuer's financial

---

or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.

[10] Refer to release text Pages 70, 74, 78 and 91.

[11] Refer to release text Page 13.

[12] Refer to Thomas Riesenberg, *Trying to Hear the Whistle Blowing: The Widely Misunderstood Illegal Act Reporting Requirements of Exchange Act Section 10A*, (2001), *available at* https://www.jstor.org/stable/40688023. Note: All quotes within this paragraph and the remainder of this section are from the source referenced herein.

statements by reviewing compliance with laws and regulations which, if violated, could materially affect the issuer's financial statements or operations." The SEC expressed concern that this was too broad because it would have "general application to companies that must comply with a multitude of statutes and regulatory schemes – from environmental to franchising, to workplace safety, to fair labor procedures laws – federal, state, local, foreign." As such, they recommended that the statutory audit requirement be limited to "specified laws and regulations where compliance problems have a direct link with the audit process."

Only after the proposal was overhauled to focus the bill's requirements on "major" or "egregious" financial fraud and illegal activity, was Section 10A finalized in 1995. We believe there is much to be learned from that journey, and it is not clear what has changed since such time that necessitates reopening a similar debate. As we point out throughout our letter, there are many parallels between the starting point of the Section 10A journey and the starting point of the Board's current NOCLAR proposal. Additionally, many of the criticisms raised by the various stakeholders throughout the Section 10A process are not dissimilar from the concerns we are outlining within this letter and the concerns raised by the dissenting Board members in their statements on the NOCLAR proposal.

Rulemaking history of PCAOB AS 2

We also see parallels between the NOCLAR proposal and the PCAOB's AS 2. In December of 2006, the PCAOB proposed a new auditing standard (AS 5) on internal control over financial reporting ("ICFR") that superseded AS 2. This was the result of the PCAOB monitoring implementation of AS 2 and determining that the audit of ICFR produced significant benefits, but those benefits came at a significant cost that far exceeded expectations. When AS 5 was proposed to supersede AS 2, the PCAOB stated that the changes in AS 5 were designed to: 1) focus the audit on matters most important to internal control, 2) eliminate unnecessary procedures, 3) scale the audit for smaller companies, and 4) simplify requirements. Many view AS 5 as being successful in maintaining the benefits of auditing ICFR while managing costs and, most importantly, focusing auditors on those matters most important to internal control. We believe proposed AS 2405 and related amendments, if adopted as written, are similar to AS 2 and would result in significant costs that far exceed expectations. We recommend that the PCAOB consider lessons learned from AS 2 as they finalize AS 2405 and related amendments.

Scope of the proposal

Definition of noncompliance with laws and regulations

We are generally supportive of replacing the term "illegal acts" with "noncompliance with laws and regulations" and the Board's rationale for doing so. Additionally, we are generally supportive of the definition of noncompliance with laws and regulations as defined in proposed AS 2405.A2. However, while we appreciate why the PCAOB has included fraud in the definition, there are several complicating factors that cause us concern with doing so. The definition of NOCLAR in AS 2405.A2 appears to be straightforward. However, Footnote 1 of the proposing release text expands the definition of NOCLAR further to include both fraud as defined under AS 2401.05 and "all other types of fraud, such as non-scienter based fraud."[13] We believe this change could potentially represent a substantial expansion of auditor responsibility (essentially amounting to seeking out negligence, which is how non-scienter based fraud has been interpreted), and would be akin to the elimination of the distinction between laws and regulations that would have a direct versus indirect financial statement impact. It is unclear whether the Board believes incorporating fraud in the definition of NOCLAR represents a significant change, as such a change has not been explained or otherwise given appropriate attention within the proposing release.

Additionally, 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. We acknowledge that fraud and noncompliance with laws and regulations are highly interrelated and appreciate the challenge in updating the auditing standards in one of these areas without impacting the other. Further, we realize that the Board currently has a project related to fraud on its mid-term standard-setting agenda. Given this interrelationship, and considering the points described above, we recommend that the Board consider the two projects concurrently rather than proposing changes to AS 2405 and AS 2401 separately and in isolation. This approach will likely lead to a more cohesive suite of standards that complement each other and can be more easily interpreted and applied by auditors, with less risk of confusion and contradiction. We view this to be similar to the PCAOB's past projects related to estimates and specialists, for which the feedback on the two proposed standards was so interrelated that the projects needed to move together and on the same timeline.

Auditor's responsibility related to illegal acts having direct versus indirect effect on the financial statements

As described within the proposal, existing AS 2405 and Section 10A(a)(1) of the Securities Exchange Act of 1934 require the auditor to identify noncompliance with laws and regulations that have a direct and material effect on the financial statements, but have fewer requirements related to the auditor's identification of other noncompliance (which has an indirect effect on the financial statements). The proposal goes on to point out that, "Section 10A(b)(1) establishes further requirements *if the auditor detects or otherwise becomes aware of* information indicating that an illegal act 'has or may have occurred.' 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.'[FN omitted]"[14] (*emphasis added*)

We understand and acknowledge the reasons the Board has outlined in the proposal for eliminating the distinction between laws and regulations with which noncompliance would have a direct effect on the financial statements and those with which noncompliance would have an indirect effect. Additionally, we believe there could be benefits to updating the auditing standards to enhance auditor attention in the

[13] Refer to release text Page 4, FN 1 - Except as noted in Section IV, the term "fraud" used in this proposing release and its appendices has the same meaning as it does in paragraph .05 of AS 2401, Consideration of Fraud in a Financial Statement Audit (i.e., an intentional act that results in a material misstatement in financial statements that are the subject of an audit). To be clear, the definition of "noncompliance with laws and regulations" includes both fraud as defined under AS 2401.05 and all other types of fraud, such as non-scienter based fraud.
[14] Refer to release text, Page 13.

area of NOCLAR (including with respect to assessing and responding to risks of material misstatement of the financial statements arising from potential noncompliance with laws and regulations that would have an indirect effect). However, we believe the topic is more complex in application than assumed in the proposal. Based on the nature of items that could have an indirect impact on the financial statements, the procedures auditors can perform over such items differ from those they can perform over items with a direct impact, especially in the context of an audit of a set of historical financial statements.

As an example, the proposal indicates that, "...noncompliance with laws and regulations by companies may result in substantial financial damage to investors through lower share prices. In addition to sanctions and fines, civil settlements, and legal costs, share prices may also be affected by reputational consequences for the companies, including lower future earnings and increases in the cost of capital. [FN omitted]"[15] While an auditor can assess such matters in the context of determining whether the current period financial statements are materially misstated, the assessment would be made more difficult by the need, as seemingly required by the proposed standards, to speculate on prospective market, counterparty or stakeholder responses to adverse publicity resulting from NOCLAR.

As a result of these differences, any auditor requirements regarding laws and regulations that do not have a direct effect on the financial statements, but with which noncompliance could have an indirect material effect on the financial statements, would need to be more clearly defined than they currently are in the proposal to make them operable and practicable.

We suggest the Board consider an alternative approach that would strengthen the auditor's procedures over NOCLAR generally while also being operable and practicable. This approach would be to maintain the distinction between the two categories of laws and regulations (i.e., direct and indirect) and to require the auditor to perform a more directed set of procedures over certain (as described further below) laws and regulations in the latter category (indirect). This could entail performing directed risk assessment procedures to focus the auditor on potential noncompliance with those laws and regulations that may have an indirect material effect on the financial statements. However, in doing so, we believe it would be appropriate for the auditor to focus their attention on those laws and regulations with which compliance may be *fundamental* to the operating aspects of the business, to the entity's ability to continue its business, or to avoid material penalties. We suggest that such risk assessment procedures comprise inquiring of management, compliance officers, and where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations. Additionally, the auditor could perform risk assessment procedures such as inspecting correspondence, if any, with relevant licensing or regulatory authorities. Such procedures could increase the likelihood that auditors may identify potential NOCLAR, which could benefit investors.

To the extent the auditor identifies or otherwise becomes aware of information indicating that noncompliance with such laws and regulations has or may have occurred, we are supportive of the requirement for the auditor to evaluate such noncompliance in accordance with proposed AS 2405.07 through .11, conditional upon the further feedback and observations we have provided in this area, as outlined below.

[15] Refer to release text Page 64.

Identification of laws and regulations with which noncompliance could reasonably have a material effect on the financial statements

Proposed AS 2405 includes a requirement for auditors to plan and perform procedures to identify the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements. It appears from the Board's description within the release text that the intention is to focus the auditor's attention on laws and regulations that could have a material effect on the financial statements.[16] However, as pointed out by Board Member DesParte, "...the filtering threshold of 'reasonably could' is not addressed elsewhere in PCAOB standards or adequately explained in the proposal. For example, it is unclear whether auditors would make this likelihood assessment considering management compliance policies, programs, processes, and controls (i.e., on a residual risk basis) or on an inherent risk basis."[17] The problems with the proposed "could reasonably" threshold are compounded because it is unclear if the auditor would be making this judgment with respect to potential noncompliance that could reasonably have a material effect today or at some other indeterminate point in the future. The lack of clarity surrounding this proposed threshold raises questions and concerns about the scope and scalability of the proposed standard.

The terminology used within the proposed standard, along with the nature of the subject matter at issue, would seemingly make the identification of laws and regulations meeting this threshold unlike other elements of risk assessment auditors perform today in conjunction with an audit. Considering the various references within the release text to the potential for future share price declines and reputational harm resulting from NOCLAR (which would not have current financial reporting impacts), and the expectations of auditors outlined by the IAG Working Group regarding information material to a company's financial operations (as opposed to the financial statements themselves) causes us to further question the connection between the auditor's current risk assessment process and what would be required by the proposed standards.[18] Without a clear framework or further guidance, in many cases, it will be very difficult to conclude that a law or regulation (especially those that could have an indirect effect) could *not*, at some point, reasonably have a material effect on a company's financial statements. As such, given the expansiveness of the proposed definition of NOCLAR, the standards, as proposed, will result in the auditor identifying a *significant* number of laws and regulations that could reasonably have a material effect on the financial statements. This will, in turn, compel auditors to expend large amounts of time and effort related to a significant number of laws and regulations in order to comply with the proposed standards,

[16] Refer to release text Page 29 – "We believe the inclusion of the phrase 'could reasonably have a material effect' would appropriately tailor the requirements to include those laws and regulations that relate to the way matters are presented (that is, recorded or disclosed) in the financial statements (for example, tax, pension, and certain securities laws) and other laws and regulations that may relate to the operations of a company with which the company's noncompliance could reasonably result in material penalties, fines, or damages to the company (for example, for a chemical company, environmental protection regulations). These laws and regulations would necessarily be relevant to the company or its operations but would not represent every law or regulation to which the company is subject. 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."

[17] Refer to Statement on Proposal to Amend PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments made by Duane DesParte on June 6, 2023.

[18] Refer to references to the potential for future share price declines and reputational harm resulting from NOCLAR within the release text at Pages 4, 17, 63-67, 69 and 73.

little of which will likely lead to the identification of or relate to actual instances of noncompliance resulting in a material misstatement of the financial statements being audited. As described above, similar concerns were raised related to the initial versions of Section 10A, including that the proposed bill was too broad and that it would require auditors to make judgments in areas outside their core competencies.

Additionally, without further clarity as to what “could reasonably” means, an auditor would have to identify all the laws and regulations applicable to the company to meet the requirements of the proposed standard. The proposal indicates that “...the auditor would be able to benefit from management’s process to identify these laws and regulations.”[19] Any such benefit, however, would clearly be limited. As the proposal goes on to state, ”[t]he auditor’s identification would not be limited to those laws and regulations identified by management when fulfilling this obligation, however, such laws and regulations are a source of information for the auditor.”[20] Additionally, auditors would be required under AS 1105.10 to perform procedures to test the accuracy and completeness of any such information produced by the company. Further, as described above, securities laws and their implementing regulations do not require a public company’s management to identify all laws and regulations to which the company is subject, and currently a company’s ICFR does not to extend to nor include internal controls related to laws and regulations with which noncompliance would have an indirect effect on the financial statements.[21] Such inconsistencies will further contribute to limitations on the auditor’s ability to benefit from management’s process in complying with the proposed standards.

Without a clear framework for identifying which laws and regulations “could reasonably have a material effect on the financial statements” and a more robust explanation of how the Board would expect an auditor to go about doing so without first identifying all laws and regulations to which a company is subject, this requirement would be impractical for auditors to comply with given the potential magnitude of laws and regulations that would need to be considered, and the significant number of laws and regulations that would likely be determined to meet this threshold, especially with respect to companies that operate globally.

Assessing and responding to risks of material misstatement of the financial statements due to NOCLAR / Identification of information indicating noncompliance with laws and regulations has or may have occurred

We believe there could be benefits to updating the auditing standards to enhance auditor attention in the area of NOCLAR, including with respect to assessing and responding to risks of material misstatement arising from potential noncompliance. We are supportive of requiring the auditor to make specific inquiries of management, the audit committee, and others regarding NOCLAR (per proposed AS 2110.54 and .56 through .58), as well as of requiring the auditor to hold a discussion about NOCLAR (per proposed AS 2110.49), subject to the concerns we have expressed herein regarding the lack of clarity in the term “could reasonably have a material effect on the financial statements." We are also supportive of including more specificity in the standards regarding how an auditor should obtain an understanding of the

[19] Refer to release text Page 29
[20] Refer to release text Page 29.
[21] See Question 10 within *Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports - Frequently Asked Questions*, at https://www.sec.gov/info/accountants/controlfaq0604.htm.

company and its environment. However, we believe certain of the proposed requirements in this area, as drafted, may be difficult to apply and operate. More specifically, our observations in this area are as follows:

- With regard to the proposed amendments to AS 2110.26, we are supportive of the concept of requiring the auditor to obtain an understanding of management's processes related to NOCLAR in the context of its potential impact on the financial statements and financial reporting process. However, as mentioned above and further discussed in the section below regarding *The role of the auditor versus the role of management,* currently a company's ICFR does not extend to nor include internal controls related to laws and regulations with which noncompliance would have an indirect effect on the financial statements. As such, proposed AS 2110.26 would lead to confusion between the responsibilities of company management and the responsibilities of the auditor in this area, which would result in challenges in application.

- With regard to the proposed amendments to AS 2110.11, we are supportive of updating this paragraph to remind the auditor of the types of communications provided by companies today that might inform the auditor's risk assessment, including related to NOCLAR. As proposed, however, the amendments to AS 2110.11 appear to be a fundamental movement from a "risk-based approach" to a prescriptive approach that does not align with the overarching concept in existing AS 2110.04 (to which the Board has not proposed amendments) that "[t]he auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures. [FNs omitted]" The proposed amendments within this paragraph would likely cause auditors to spend significant time and effort with potentially little incremental benefit to the risk assessment, and would not be practicable for an auditor to apply in many cases. As pointed out in the proposing release, existing AS 2110.11 provides a list of procedures the auditor is required to consider performing, whereas the proposed amendments would require the auditor to perform all procedures described in the paragraph.[22] Additionally, whereas existing AS 2110.11 refers to "[r]eading publicly available information about the company *relevant to the evaluation of the likelihood of material financial misstatements and, in an integrated audit, the effectiveness of the company's internal control over financial reporting*..." (*emphasis added*), a similar opportunity to apply judgment in evaluating relevance to the audit is absent from the proposed standard.

  The nature and potential extent of some of the types of information referenced in the proposed Note in paragraph .11 pose further challenges. We believe it is unlikely that an auditor would be able to locate and analyze every public reference about the company they are auditing, including all references within media reporting and social media posts, even with the use of technology. This would be increasingly more difficult for large multi-national companies, large companies that have significant online presences, or companies that are covered by multiple analysts. It would be particularly challenging, if not impossible, for auditors to assess the relevance and reliability of all media reporting about a company, including determining how to consider and assess the

[22] Refer to release text Page 37.

relevance and reliability of external information, including whether it conflicts with other sources of information. The volume of information that the proposal would require auditors to locate and analyze, as well as assess the relevance and reliability of, is impracticable and would likely result in significant challenges to the auditor being able to comply with the proposed requirements. Even if the auditor could comply with such requirements, it would be at great cost, and may not provide corresponding benefit in the context of the objective of a financial statement audit or an audit of ICFR.

Determining the possible effect on the financial statements and other information and performing additional procedures

Proposed AS 2405.09b requires the auditor, when they determine it is likely that NOCLAR has occurred, to "[p]erform additional procedures as necessary to determine whether the likely noncompliance... (2) results in other information in documents containing audited financial statements, or the manner of its presentation, being materially inconsistent with information appearing in the financial statements or containing a material misstatement of fact. [FN omitted]" Especially when combined with the example in the proposing release describing a situation in which the auditor would be required by the proposed standard to perform procedures over KPIs disclosed by a company to determine whether their annual report is materially misstated, the proposed change causes us to share the concerns expressed by Board Member DesParte in his statement on the proposal.[23] Board Member DesParte expressed that "[i]t seems that the proposal may be establishing a requirement beyond existing requirements in *AS 2710: Other Information in Documents Containing Audited Financial Statements* for auditors to validate whether management has appropriately disclosed information on noncompliance outside the audited financial statements. [FN omitted]"[24] We believe that the auditor's current responsibilities over other information under AS 2710 remain appropriate. If, however, the PCAOB believes a broader auditor responsibility over other information is necessary, the prior "other information" project should be added back to the Board's standard-setting agenda and any potential expansion of the auditor's obligations should be considered as part of that project.

Auditors are not lawyers or forensic specialists

We acknowledge that there are certainly some similarities between what is currently required of an auditor by existing AS 2405 and Section 10A when they become aware of NOCLAR, and what is required by proposed AS 2405. However, certain of the differences, while they may appear nuanced on the surface, are cause for concern.

Existing AS 2405.10 requires that, "[w]hen the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. In doing so, the auditor should inquire of management at a level above those involved, if possible. If management does not provide satisfactory information that there has been no illegal act, the auditor

[23] Refer to release text Page 45.
[24] Refer to Statement on Proposal to Amend PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments made by Duane DesParte on June 6, 2023.

should – (a) Consult with the client's legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements. Arrangements for such consultation with client's legal counsel should be made by the client [and] (b) Apply additional procedures, if necessary, to obtain further understanding of the nature of the acts." Existing AS 2405.11 provides examples of additional audit procedures that might be performed if considered necessary. Further, existing AS 2405.12 requires that, "[w]hen the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel [the client's legal counsel, as referenced in existing AS 2405.10a], that an illegal act has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit."

By comparison, proposed AS 2405.07 requires that, "[w]hen the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred (regardless of whether the effect of such noncompliance is perceived to be material to the financial statements), the auditor must (1) obtain an understanding of the nature and circumstances of any such noncompliance; and (2) determine whether it is likely that any such noncompliance occurred. [FN omitted]"

While existing AS 2405.12 references the auditor concluding on whether "an illegal act has or is likely to have occurred," the exclusion from the proposed standard of important contextual language within this and other paragraphs of the existing standard appears to represent a significant change in the auditor's responsibilities.

In practice today, an auditor's determination of whether it is likely that NOCLAR has occurred is largely based on evaluating what a company's management and their specialists (i.e., counsel and other specialists involved in investigations) have done, along with their assessments and conclusions. Only if the auditor determines that the company has not done enough, does the auditor independently perform additional procedures. This is aligned with the fundamental concept that making such a determination is beyond the auditor's professional expertise, as described in paragraph .03 of existing AS 2405, entitled *Dependence on Legal Judgment.* Paragraph .03 states that, "[w]hether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence. An auditor, in reporting on financial statements, presents himself as one who is proficient in accounting and auditing. The auditor's training, experience, and understanding of the client and its industry may provide a basis for recognition that some client acts coming to his attention may be illegal. However, the determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law." Not only is this important contextual language absent from the proposed standard, but the fundamental concept is missing. Without the contextual language such as that included in existing AS 2405.03 and .12, the proposed standard would obligate the auditor to "determine whether it is likely noncompliance has occurred" and further implies that in doing so, such assessments are expected to be made independent of and with little regard to management's own assessment. The additional requirement under the proposed standard for the auditor to communicate their affirmative determination to the audit committee, which does not exist under Section 10A, further highlights this distinction.

While the Board states within the proposing release text that, "[s]imilar to the existing standard, the proposed amendments do not state that the auditor is required to make a definitive legal determination about whether noncompliance has occurred," in practice, affirmatively concluding on likelihood of noncompliance, particularly with little input from the company or regard to management's own assessment, would be tantamount to making a legal judgment. As described in existing AS 2405.03, making such a determination is beyond the auditor's professional competence and, often, there is significant ambiguity such that a determination could only be made by a court of law. There could even be a view that this would require auditors to engage in the unauthorized practice of law. As such, we believe it is important that the PCAOB engage with those stakeholders who could potentially be of this view, including the legal community.

The Board acknowledges in the proposal that, "…the auditor may need to engage legal counsel or other specialists to assist the auditor in (i) understanding certain laws and regulations; (ii) assessing and responding to the risk of material misstatement of the financial statements due to noncompliance with those laws and regulations; (iii) evaluating whether it is likely the noncompliance occurred; or (iv) developing more rigorous inquiries of management or others to understand the circumstances in which the noncompliance occurred."[25] We believe this is an understatement, as we foresee that auditors will need to engage legal counsel and likely other specialists on most if not all engagements. The proposed requirements will significantly expand auditors' need for expertise from significant numbers of lawyers, legal experts, fraud experts, and other specialists, as a result of the broad spectrum of all laws and regulations that will need to be assessed.

Not only does this demonstrate that the proposed requirements are beyond the expertise of an auditor, but it may also be prohibitively expensive (as discussed further below). Additionally, the vast number of specialists that would need to be engaged by auditors will result in resource constraints, as there are likely not enough specialists with the appropriate skills in the marketplace to meet the requirements or it would be impractical to engage them timely to be in a position to meet issuer reporting timelines. For example, if an issuer were to engage external counsel regarding potential noncompliance with a law or regulation, an auditor would not be able to utilize that same law firm to assist them in their audit. In some highly complex areas, there may be only one firm that possesses the necessary specialized skill and knowledge to provide the relevant advice.

Moreover, we believe that in many cases it will be extremely challenging for an auditor's specialist to be able to make a determination that is definitive enough to allow the auditor to conclude on whether it is likely that NOCLAR has occurred. Given such a specialist does not work for the company, and considering issues around attorney-client privilege with respect to information shared (as discussed further below), it is likely that an auditor's specialist may feel they cannot opine on something for which, arguably, they do not have access to all the facts. Even in situations in which a legal expert could potentially opine on the likelihood of a company's noncompliance with a law or regulation, in many cases this would not be achievable in the timeframe in which an audit must be completed, for example, with respect to a whistleblower tip or allegation relating to an indirect law or regulation that arises immediately prior to a filing deadline. Situations in which an issuer completes an acquisition close to a filing deadline would

[25] Refer to release text Page 43.

present particular challenges for auditors in trying to fulfill the proposed requirements with respect to the laws and regulations to which the acquired entity is subject.

As proposed, the standard does not indicate how the auditor should proceed when they are unable to conclude on the likelihood of potential NOCLAR, other than that such inability must be communicated to the audit committee. While it is currently uncommon for issuers to be unable to timely file their financial statements, instances of such would increase many times over if auditors are required to conclude on the likelihood of each potential instance of NOCLAR identified during the audit (regardless of materiality) prior to the issuance of the audit report.

The role of the auditor versus the role of management

It takes the collective efforts of company management, audit committees, auditors, and regulators to foster a system that supports high-quality financial reporting and audits. Management makes judgments about disclosures in the financial statements in accordance with US GAAP (or the applicable financial reporting framework) and considers whether disclosures elsewhere in periodic filings are required by SEC disclosure requirements. As proposed, the standards confuse, and potentially duplicate certain responsibilities of management.

For example, under ASC 450, a company is required to recognize an estimated loss from a loss contingency when it is probable and can be reasonably estimated; and disclosure within the financial statement footnotes is required when a loss contingency is probable but cannot be reasonably estimated or is reasonably possible. Proposed AS 2405 and the accompanying release text utilize terminology such as “could reasonably,” “may,” “might,” and “likely” that doesn’t appear to be aligned with ASC 450 in regard to the likelihood determination related to loss contingencies, introducing ambiguities in the application of determining the effect on the financial statements in accordance with US GAAP. Especially when considered in combination with the investor expectations outlined by the IAG Working Group in 2017 and the Board’s AS 1000 exposure draft, which proposes to expand the auditor’s responsibility to require them to make a judgment concerning the fairness of the overall presentation of the financial statements that goes beyond the applicable financial reporting framework, such ambiguities would result in confusion regarding companies’ responsibilities to evaluate the recognition of contingencies and related disclosures in the financial statements under GAAP and the auditor’s requirement to determine the possible effect on the financial statements, including material misstatements, when potential noncompliance is identified.

As described in AS 2815.03, “The independent auditor's judgment concerning the ’fairness’ of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles. Without that framework, the auditor would have no uniform standard for judging the presentation of financial position, results of operations, and cash flows in financial statements.” Consistent with the view offered in our comment letter in response to the Board’s AS 1000 proposal, we believe that a requirement for the auditor to make a judgment concerning the fairness of the overall presentation of the financial statements that goes beyond the applicable financial reporting framework is not appropriate. Further, in making such an assessment, it could be argued that the auditor would be essentially standing in the shoes of an issuer’s management and its disclosure counsel and assessing whether - notwithstanding the issuer's compliance with the extensive information and disclosure obligations imposed by the applicable financial reporting framework and SEC requirements – the issuer's financial statements should contain additional information.

The proposed standards also create conflict in the area of processes and controls. The term internal control over financial reporting is defined by SEC rules.[26] Currently, a company's ICFR does not extend to nor include internal controls related to laws and regulations with which noncompliance would have an indirect effect on the financial statements. Furthermore, the COSO Framework, which is the internal control framework most widely used by issuers to assert compliance with the requirements of Section 404(a) of the Sarbanes-Oxley Act, is clear that there are three separate types of internal controls: those that affect a company's operations, those that affect a company's compliance with laws and regulations, and those that affect a company's financial reporting.[27] Proposed AS 2405 and related proposed amendments to AS 2110 seem to imply there is an expectation that a company has processes and controls in place related to identifying events that "have" or even "may have" occurred around laws and regulations with which noncompliance would have an indirect effect on the financial statements, but is unclear as to whether companies would be expected to include such processes and related controls in their ICFR framework. As such, the proposed standard will result in conflicts between what is part of management's currently required ICFR and the auditor's requirements under proposed AS 2405 and AS 2110.

Furthermore, the proposal gives little credence to the fact that public companies have compliance organizations in place for the purpose of preventing, identifying, and disclosing NOCLAR that employ teams of experts trained specifically for legal compliance functions and management of related programs. Further, an issuer's principal officers are required to sign certifications quarterly and annually related to the company's disclosure controls and procedures ("DC&P) and ICFR. The proposed standard would require auditors to independently perform many of the same procedures a company's compliance organization would have already performed, with limited ability to use the work of management, essentially seeking the auditor's certification on the company's compliance. Although it would still represent a significant expansion of the auditor's responsibilities, a more practicable alternative, and one that better aligns with the accountability framework, might be to focus the proposed requirements on

[26] Refer to Securities Exchange Act Rule 13a-15(f) - The term internal control over financial reporting is defined as a process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the registrant's assets that could have a material effect on the financial statements.

[27] Refer to COSO's *Internal Control – Integrated Framework Executive Summary* at https://www.coso.org/Shared%20Documents/Framework-Executive-Summary.pdf and PCAOB's *A Layperson's Guide to Internal Control Over Financial Reporting (ICFR)* at https://pcaobus.org/news-events/speeches/speech-detail/a-layperson-s-guide-to-internal-control-over-financial-reporting-(icfr)_112.

the auditor's assessment of noncompliance through an evaluation of a company's existing compliance program.

To the extent there is a view by the Board or others that companies' processes and procedures related to preventing, identifying, and disclosing NOCLAR are lacking, such that an assessment of the compliance programs of public companies would not meet the intended objective, improving companies' compliance programs solely through the auditing standards is not an appropriate approach. Similar to the concerns that were expressed related to the initial versions of Section 10A, as proposed, the standards seem to shift the detection of and accountability for NOCLAR from corporate management to the auditor. Similarly, displacing the obligation to evaluate and enforce the disclosure of NOCLAR to the auditor from management in the absence of objective disclosure regulations or reporting standards would create conflicts. Therefore, we believe that the FASB and SEC would need to make changes to the accounting and disclosure standards and/or related regulations (e.g., components of Regulation S-K) as a first step to avoid undermining the long-established accountability framework within the financial reporting ecosystem. Company management would then be able to adopt and apply those standards and regulations to their financial reporting processes. Only after that can auditors conclude, in the context of an audit, on whether management's application of the standards and regulations resulted in the preparation of financial statements that are free of material misstatement and, when applicable, on the effectiveness of the company's internal control over financial reporting.

Costs and benefits of NOCLAR proposal require further study

Costs of the proposed standard could be in the billions

The PCAOB's NOCLAR proposal explains 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."[28] However, the PCAOB does not provide or quantify the potential costs. Given the complexity of the proposal and the myriad of potential variables, we recognize that developing a precise estimate of the associated costs would be impossible. However, we have considered various relevant datapoints, all of which lead us to conclude the cost will be multiple billions of dollars.

As one point of reference, we considered that the NOCLAR proposal has the potential to introduce a significant increase in audit effort and thus audit fees, similar to the extensive change in the scope of the audit as a result of the implementation of the new auditing standard on internal control over financial reporting with the adoption of the Sarbanes-Oxley Act of 2002 (SOX). According to Audit Analytics, total audit fees for FY 2021 were $15.5 billion; the average SEC registrant paid $2.176 million in audit fees, which represents a $34,000 or 1.5 percent increase over FY 2020.[29] The modest increase in fees paid in FY 2021 can be attributed in part to the fact that there were minimal changes in accounting and auditing standards at that time and thus minimal scope changes in the audit relative to new standards or requirements. Between FY 2003 and FY 2004, total audit fees increased by nearly 59%.[30] If the proposed

[28] Refer to release text Page 81.
[29] See Audit Analytics Report, *Twenty Year Review of Audit and Non-Audit Fee Trends*.
[30] Ibid.

changes have at least the same impact to the scope of the audit as SOX did, total audit fees could increase to $24.6 billion (an increase of $9.1 billion). While SOX resulted in a significant increase in auditor time and effort, as would the NOCLAR proposal, the introduction of the ICFR audit did not require additional specialized skills and knowledge that were outside the core competencies of financial statement auditors. The need for such expertise in order to comply with the proposed NOCLAR standard would be an added dimension, indicating that the estimated increase in audit fees described above could be low.

Considering costs from another angle, as acknowledged by the Board in the proposal, there will be substantial costs to develop methodologies, train auditors, and engage specialists. Auditors will need to confer with specialists, including a range of legal experts, fraud experts, and other specialists to both inform a firm centrally from a national office perspective, and to participate in individual issuer audits. These costs will be passed along to the companies being audited, as overseen by the company's audit committee. It is hard to estimate what these costs would be, however, a relevant datapoint may be the costs companies incur to engage legal experts. For example, according to a Wolters Klowers report, the typical large corporation in their dataset spent around 0.4 percent of company revenue on outside counsel.[31] Considering total revenue earned by companies in FY 2021, this would indicate that companies incurred approximately $148 billion in external legal costs that year.[32] Some portion of that amount would also be incurred by auditors to obtain the legal expertise needed to comply with the proposed standards.

These estimated costs that would be incurred by the auditor do not account for any increased costs that companies would incur for their own internal and external counsel, finance teams, and related business units to prepare significantly more information for the auditor and spend significantly more time assisting the auditor in complying with the proposed standards. Further, audit committees will spend significantly more time and effort to comply with the proposed requirements, potentially including engaging specialists to assist them in fulfilling their responsibilities, as they would likely have the same challenges as auditors in terms of their core competencies. All of these costs will ultimately be passed down to investors.

Evidence to support the need for such broad change

The Board notes that the proposal is based, in part, on observations from their oversight activities, including audit deficiencies identified in inspections related to noncompliance with existing AS 2405 and enforcement activities where the firm failed to adequately comply with existing AS 2405 or the provisions of Section 10A, or both.[33] Additionally, the proposal describes that investor harm from violations of laws or regulations can be significant and references recent, highly-publicized events in which such harm occurred. It appears, however, that a detailed analysis of the frequency and monetary impact of such events has not been performed. We have sought out information available in the public domain but have not been able to identify objective, empirical evidence that supports the need for such a fundamental

[31] See https://www.wolterskluwer.com/en/expert-insights/legalview-insights-legal-spend-is-up-but-spread-among-fewer-vendors.
[32] Using revenue data from Audit Analytics (FY 2021 revenue of $37 trillion multiplied by .4% = $148 billion).
[33] Refer to release text Page 15.

shift in the scope of financial statement audits.[34] For this reason, among others, we believe further study and evaluation (as described in more detail above) are critical to developing an updated NOCLAR standard that will effectively enhance audit quality and, thus, investor protection.

Benefits of the proposed standard may not be achieved

We do not believe the benefits the Board is expecting will be achieved as a result of the proposed standard. For example, the proposing release cites highly publicized matters that have drawn attention to the role of the auditor in detecting violations of laws and regulations and the related investor harm from these matters. It further states that many investors would prefer earlier and enhanced communication and reporting of noncompliance, which could improve financial reporting quality and thereby allow investors to make better-informed decisions regarding capital allocation and enhance their monitoring of company management (an example that highlights the existing expectation gap). We do not believe it is possible to prevent these forms of noncompliance. Further, it is not possible or appropriate for a PCAOB standard alone to compel issuers to communicate and report noncompliance sooner.

To illustrate this point, we considered the following example from the proposal:

> "The auditor could identify environmental protection regulations as those with which noncompliance could reasonably have a material effect on the financial statements. In these instances, the auditor would plan and perform procedures to understand management's process for maintaining compliance and test the design and operating effectiveness of relevant controls. However, the auditor could also obtain a company's specialist report evaluating compliance. [FN omitted] The auditor could also obtain reports issued by state or federal authorities (for example, the U.S. Environmental Protection Agency or the California Environmental Protection Agency). In addition, the auditor may consider whether an auditor's specialist should be involved to assist the auditor in evaluating whether any evidence obtained includes information indicating noncompliance with laws and regulations has or may have occurred."[35]

---

[34] In looking to speeches given by the SEC staff at the annual AICPA conference from 2000 to 2022 NOCLAR/Section 10A was only discussed on two occasions, once in 2000 and again in 2011, one of which led to a request for the United States General Accounting Office to perform a review of reporting under Section 10A. Both the report on the original review, which was published in 2000, as well as a subsequent report published in 2003 based on an updated review, identified no evidence that the low number of 10A filings was the result of a failing by auditors.
Based on a review of inspections data downloaded from Audit Analytics for the years 2009 through 2021 that there were no instances of inspection findings related to AS 2405 or illegal acts. Further, the most recent Survey of Inspection Findings for 2022 provides information about those areas of inspections around the world with the highest rates of deficiencies. We note that NOCLAR and/or illegal acts does not appear in those top areas.
From a review of Accounting and Auditing Enforcement Releases for January 1, 2014 through June 30, 2019, we identified seven SEC enforcement actions with reference to a Section 10A violation out of a total 531 enforcement actions reviewed which represent only 1.3% of enforcement actions over five and a half years reviewed.
[35] Refer to release text Page 32.

In using the example from the proposal above, assume that in testing management's process for maintaining compliance with environmental protection regulations the auditor identifies an employee allegation of noncompliance.[36] At the time of the audit, management's investigation into this allegation is ongoing and management has not concluded whether a violation has occurred or the potential impact on the financial statements. The most recent specialist's report does not indicate there are any instances of noncompliance, and recent regulatory reports from the EPA do not contain violations. Issuers are required to recognize an estimated loss from a loss contingency when information available prior to issuance of the financial statements indicates it is probable and can be reasonably estimated; and disclosure within the financial statement footnotes is required when a loss contingency is probable but cannot be reasonably estimated or is reasonably possible. Investigations into potential misconduct or violations of law can take considerable time and often the amount of the loss cannot be reasonably estimated until all the facts are known. Assume, in this case, that neither the criteria for recognition nor disclosure have been met based on information available prior to issuance of the financial statements. In applying the requirements of proposed AS 2405, which would involve a *significant* number of incremental procedures upon the identification of information indicating potential noncompliance, the ultimate outcome would be that no new information would be disclosed by management, nor would there be any effect on the auditor's engagement report (based on requirements in proposed AS 2405.19). As such, would not result in investors receiving information on noncompliance sooner.

Other observations

Consideration of legal privilege

Today auditors are required to obtain sufficient information to satisfy their obligations under AS 2405 and Section 10A related to instances of noncompliance of which they become aware, while an issuer's internal and external counsels' obligations relate to preserving attorney-client privilege and to protecting the issuer from inadvertent waiver of this privilege. These potentially conflicting demands of the legal and accounting professions are currently governed in substantial party by the *ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, and the related *AICPA Statement on Auditing Standards No. 12, adopted in 1976* (together known as the "Treaty"). The Treaty strikes a delicate balance between avoiding potential waivers of attorney-client privilege and responding to auditor's needs for information to provide assurance on clients' financial statements, as there is a natural tension between these competing demands. Although much has changed with respect to accounting, financial reporting, auditing, and litigation since these statements were approved, the Treaty has stood the test of time with few substantive amendments being made to it in the last 40+ years. The ABA views a key contributor to its longevity to be that its development was premised on some basic ground rules. These ground rules place limitations on the information that can be provided to the auditor without risking the waiver of

[36] According to the 2021 Navex Risk & Compliance Hotline & Incident Management Report there were 1.3 million individual reports across more than 3,000 organizations. The median substantiation rate for allegations or reports was 42%. The median case closure time was 39 days, and anonymous reports took much longer to close. Based on these details it could be likely this allegation would not be resolved by the completion of the audit.

privilege.[37] The proposal, if adopted, will result in an exponential increase in the amount of information auditors will be required to request from issuers and their counsels related to potential NOCLAR, not all of which may fall within the ground rules of the Treaty, which would pose significant challenges for auditors in obtaining sufficient information to satisfy their obligations.

Further, the release does not contemplate or consider the increased risk to the company's preservation of legal privilege nor does it contemplate or consider whether a company would need to waive applicable privileges, or other legal protections, given the increased sharing of information between the company and the auditor that would be required. This increased sharing of information will, at a minimum, result in additional time and cost associated with navigating the privilege discussions and could open up issuers to negative legal consequences, which would outweigh the associated benefits, as much of the information shared may not have a financial reporting impact. Given the breadth of information that could be required to be shared, the needs of the company and its external counsel to preserve privilege may even result in instances in which the auditor is put in the position of qualifying or including a scope limitation within its opinion. There is also the potential that, in complying with the proposed standard, auditors could seek information regarding matters that have not been assessed by a company's legal counsel, which would result in a lack of privilege, even though the auditor would be performing, in essence, a legal assessment.

Effective date

With regards to an effective date for the proposed standard, it will only be after the fundamental questions discussed herein have been resolved that auditors would be able to begin the process of implementing any amended standards, and that period would need to include time for any additional training and procuring of resources with the appropriate legal or other skill sets. In its current form, we expect audit firms will require multiple years to adequately prepare to fulfill the proposal's requirements.

Additional Feedback on Questions Posed in the Proposing Release

See below for responses to certain specific questions outlined in the release.

Proposed Amendments Related to a Company's Noncompliance with Laws and Regulations

Introduction and objectives

Q4. Is the introduction to proposed AS 2405 sufficiently clear? If not, how should the introduction be clarified?

The language in proposed AS 2405.01 may lead to a misunderstanding about the auditor's responsibilities. We are concerned the proposed language will introduce confusion into the established legal landscape in this area. We agree with the auditor's fundamental role to serve the public interest within the financial

[37] Refer to *The ABA Statement on Audit Responses: A Framework that Has Stood the Test of Time*, by Alan J. Wilson, Stanley Keller, Randall D. McClanahan, Noel J. Para, James J. Rosenhauer, and Thomas W. White, Audit Responses Committee, ABA Business Law Section.

reporting ecosystem and enhance the confidence and trust of investors in financial reporting. As noted in the proposing release text, "the independent public accountant… owes ultimate allegiance to the corporation's creditors, stockholders, as well as to [the] investing public."[38]

Plan and Perform Procedures Related to Noncompliance with Laws and Regulations

Q15. Are auditors using technology-assisted audit procedures to assess and respond to risks of material misstatement due to noncompliance with laws and regulations or to identify information indicating that noncompliance with laws and regulations has or may have occurred? If so, describe those audit techniques.

Auditors currently use technology-assisted audit procedures to assist them in executing various audit procedures, which may include procedures related to NOCLAR and fraud. However, given the nature of the judgment and expertise required to both identify potential instances of noncompliance and then evaluate those occurrences, the benefits of technology-assisted procedures will be limited. Further, AS 1105 requires auditors to consider the relevance and reliability of information used as audit evidence. As such, even if auditors were to use technology (e.g., artificial intelligence) to assist them in complying with the requirements of the proposed standards, they would still have to assess the relevance and reliability of the information gathered, analyzed, summarized, etc., which would require significant time and effort.

Communicating Noncompliance with Laws and Regulations

Q33. Does the timing of the proposed communications (that is, "as soon as practicable") to management and the audit committee pose any particular challenges to the auditor? If so, how should the proposed requirement be changed? / Q35. Does the requirement to communicate the results of the auditor's evaluation of information indicating noncompliance with laws and regulations has or may have occurred pose any particular challenges? If so, how should the proposed requirement be changed?

We are concerned regarding the requirement for the auditor to communicate to the audit committee information indicating potential noncompliance prior to the auditor's evaluation of whether the noncompliance has likely occurred or of any financial statement impacts. Given the number of potential matters that could arise, and the fact that reporting is required regardless of perceived materiality of the occurrence, the requirement for the auditor to communicate to the audit committee essentially all instances observed "as soon as practicable" may have the effect of shifting the focus of the auditor and the audit committee away from more important matters, which could be detrimental to audit quality. Further, these changes in the communications will result in a substantial increase in communications by the auditor to the audit committee. Since the requirements to identify laws and regulations extend beyond financial reporting, this could impact audit committee charters and other governance infrastructures at companies.

Amending Other PCAOB Standards to Improve the Auditor's Consideration of Noncompliance with Laws and Regulations in the Audit

[38] Refer to release text Page 26.

Q48. Is the proposed amendment to AS 4105.23 sufficiently clear? If not, what changes are necessary and why? / Q49. Is the timing for any required communications in proposed AS 4105.32 reasonable? If not, what changes are necessary and why?

The proposed Note to AS 4105.23 indicates that if in performing an interim review, the accountant becomes aware of information indicating NOCLAR has or may have occurred, the accountant must determine its responsibilities under AS 2405 and Section 10A. By itself, this Note and the related footnote could be interpreted to mean the auditor must use any information obtained as part of the interim review to comply with AS 2405 and Section 10A in the context of the annual financial statement audit (and within the associated timelines). However, when considered in conjunction with the requirement in proposed AS 4105.32 that, "[a]ny required communications under those standards [AS 2401 and AS 2405] or rule [Section 10A] should be made as soon as practicable and prior to the registrant filing its periodic report with the SEC," this would seem to imply that the auditor is required to perform a full evaluation of any potential instance of NOCLAR, as required by proposed AS 2405, prior to the company's periodic filing (i.e., the Form 10-Q). Given the potential number of matters that could arise, and a departure from a focus on only those that could have a direct and material effect on the financial statements, it is unrealistic to think that an auditor would always be able to form an affirmative conclusion on all such matters within the compressed interim financial reporting timelines. While it is currently uncommon for issuers to be unable to timely file their financial statements, instances of such would increase many times over if auditors are required to apply the proposed standards, in effect, on both an interim and annual basis.

Unintended Consequences

Q65. The Board also requests comment on the potential unintended consequences of the proposal on competition in the market for audit services. How and to what extent could competition be affected by the proposal? How would smaller firms be affected? Would audit fees be meaningfully affected by the proposal? Would the availability of qualified auditors in the market be meaningfully affected by the proposal?

As pointed out within the Board's economic analysis, smaller firms typically do not have access to employ as many "in-house" specialists as larger firms do and, therefore, could be more affected by the costs of retaining auditor-engaged specialists.[39] Given the breadth of the proposal and the significant amount and types of expertise that it could require, smaller firms would have to rely heavily on external resources in order to comply. Such costs, along with the limited availability of qualified resources, could exacerbate current trends in which smaller firms are, or are considering, exiting public company auditing.

*****

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

[39] Refer to release text Page 81.

Amendments, and we look forward to future engagement. As the Board gathers 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,

Dennis J. McGowan

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

cc:

PCAOB
Erica Y. Williams, Chair
Duane M. DesParte, Board member
Christina Ho, Board member
Kara M. Stein, Board member
Anthony C. Thompson, Board member
Barbara Vanich, Chief Auditor

SEC
Paul Munter, Chief Accountant
Diana Stoltzfus, Deputy Chief Accountant