



August 7, 2023

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

**RE: PCAOB Rulemaking Docket Matter No. 051**

Dear Madam Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB's) proposal, *Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations*, included in PCAOB Release No. 2023-003.

**We provide audit and assurance services to build trust in society**

Our purpose is to build trust in society and solve important problems. The most common way we fulfill that purpose is by providing quality, independent audits of financial statements and internal control over financial reporting (ICFR). We agree with the PCAOB that it is (1) important for auditors as part of their responsibility to build trust to have obligations with respect to noncompliance with laws and regulations (hereafter referred to as "noncompliance") and (2) appropriate for the PCAOB to consider potential changes to their standards in this area. As the PCAOB rightly notes, instances of noncompliance can result in material fines and penalties and other financial consequences that, together with reputational consequences, can affect the financial interests of investors. Highly publicized matters have drawn attention to the role of the auditor in detecting violations of laws and regulations, including consumer, environmental, and other regulations.

Notwithstanding our support for the Board's exploration of potential changes, for the reasons we set forth in this letter, we do not support the proposal in its current form. Our concerns with the proposal stem from the Board's decision to significantly expand the auditor's objective from detecting noncompliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts to include identifying whether there are instances of noncompliance with a broad range of laws and regulations that have or may have occurred (including those laws and regulations that relate to the company's operations and are indirect in nature). However, we support the potential for changes to current audit procedures regarding noncompliance when such changes would support useful and timely financial reporting, build trust in financial statements, and enhance the relevance of financial statement audits. We stand ready to engage constructively to play our part in helping the Board develop practical ideas and facilitate a more fulsome dialogue to advance the PCAOB's objectives.

We are aware that some stakeholders advocate expanding the scope of audits of general purpose financial statements to address a much wider scope of issuer compliance with laws and regulations. The PCAOB has observed that a change in current standards would be required to advance that objective. We believe the PCAOB's proposal would have the practical effect of incorporating compliance-oriented risk assessment, testing programs, and communication routines into audits conducted in accordance with PCAOB standards.

Today, external auditors do not typically provide assurance over a wide scope of issuer compliance with laws and regulations. Rather, they can be engaged to provide assurance on various compliance assertions.



For example, we are often engaged to perform special purpose compliance engagements, such as with respect to aspects of broker-dealer regulations, mortgage and government grant stipulations, and other regulatory and contractual requirements. Those services can address various objectives by users of the assurance. Importantly, however, those engagements are typically different from an engagement to audit the financial statements because, in part, the scope of the services in many cases is not aligned with financial reporting objectives, timelines, and what is material in the context of an audit of the financial statements as a whole. And, while similar, the nature, timing, and extent of procedures and communication of results often differ as well and are designed in relation to the compliance objectives and specific needs of users. Our experience and comments on the proposal are drawn from this context.

### **We have significant concerns with the proposal as drafted**

We believe the proposed amendments are unlikely to produce the desired outcome of increased investor protection in a meaningful or cost-effective way because the proposal lacks an adequate framework and is not sufficiently coordinated with management's own responsibilities. Most significantly, the proposal lacks clarity in terms of the scope of laws and regulations on which the auditor should be focused. Today's distinction between laws and regulations that have a direct and material effect on the determination of financial statement amounts and other laws and regulations is important in the context of a financial statement audit and is consistent with the approach in Section 10A of the Securities Exchange Act of 1934 and international and US auditing standards.

The proposal would require auditors to serve effectively as compliance monitors — which has the potential to undermine auditor independence and could result in significant unintended legal consequences for companies and auditors. What is proposed goes well beyond the auditor's expected competencies in a financial statement audit and would likely require extensive and broad legal expertise. The effects would be even more significant for multinational companies and those that operate in highly regulated environments.

Importantly, management would need to prepare documentation and representations on compliance with the full range of laws and regulations, which can be voluminous and complex, to which a company is subject to serve as a basis upon which auditors would assess management's assertions. This goes beyond what is expected of management under the current statutory regime and underpins why Congress took a more limited approach in passing Section 10A. Our concerns are further explained in the appendix to this letter.

### **Certain areas warrant broader outreach and further consideration before moving forward**

In the balance of this letter, we outline considerations that should be taken into account as the Board pursues how it can change auditing standards pursuant to its own remit, as well as our views on more holistic approaches, which would require close coordination with others such as the SEC and FASB. Given the significant impact the revised standard would have on companies (and their counsel) and auditors, we believe that broader outreach and discussions should be conducted before the PCAOB determines how to proceed. The Board would benefit from a public, multi-stakeholder discussion to help develop practical ideas to advance its objective of investor protection more holistically.

This discussion should focus separately and distinctly on what can be achieved in the context of a financial statement audit and whether there is a need for broader changes across the financial and legal ecosystems in order to appropriately support an auditor's expanded responsibility for evaluating a company's compliance with laws and regulations. We believe the areas discussed below should be explored as part of a broader public debate.



Audits conducted in accordance with PCAOB standards are intended to meet the needs of investors and add to investor confidence in financial reporting by contributing to the reliability, completeness, and timeliness of such reporting. Today, auditors' obligations around noncompliance are focused on "procedures designed to provide reasonable assurance of *detecting* illegal acts that would have a direct and material effect on the determination of financial statement amounts."<sup>1</sup>

Importantly, current PCAOB standards<sup>2</sup> and Section 10A already require auditors to act any time they detect or become aware of information concerning a possible illegal act (*whether or not perceived to have a material effect on the financial statements*). The expected response in circumstances in which the auditor becomes aware of potential instances of illegal acts that relate to a company's operations, which have more of an "indirect" effect,<sup>3</sup> is the same as what is expected when auditors detect illegal acts that directly affect the determination of financial statement amounts. Auditors are required to obtain sufficient information to evaluate the effect on the financial statements (including any contingent monetary effects, such as fines, penalties, and damages). This often involves consultation with the company's legal counsel as well as specialists employed or engaged by the auditor. Auditors are required to inform the appropriate level of management and assure that the audit committee is adequately informed of illegal acts that have been detected or otherwise come to the attention of the auditor, unless the illegal acts are "clearly inconsequential."<sup>4</sup> If the illegal act has a material effect on the financial statements, auditors are required to conclude whether senior management has taken timely and appropriate remedial actions with respect to the illegal act.

This framework appropriately takes into account the need for auditors to focus on noncompliance that ultimately would have a material effect on the financial statements. With that focus in mind, we would support measured actions to increase the likelihood that auditors become aware of potential noncompliance with those laws and regulations that are fundamental to the operating aspects of the company's business, its ability to continue its business, or to avoid material penalties, and appropriately respond. Such actions the PCAOB could consider include:<sup>5</sup>

- Reinforcing the auditor's existing obligations under PCAOB standards and Section 10A, for example, by explaining how auditors may become aware of indicators of potential noncompliance that would require a response (e.g., how auditors might evaluate a company's whistleblower program and engage in a deeper dialogue with management and audit committees).
- Expanded risk assessment procedures as contemplated by the changes proposed to AS 2110<sup>6</sup> — understanding how management considers relevant laws and regulations and designs processes and controls relating to compliance, as well as a focus on the outcome of those processes in designing and performing audit procedures, with a greater emphasis on laws and regulations beyond those that directly impact a financial statement line item.
- An increased focus on inquiries of management, audit committees, internal audit, legal counsel, and others about potential noncompliance, supported by additional written representations.

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<sup>1</sup> 15 U.S. Code § 78j-1(a) (emphasis added).

<sup>2</sup> PCAOB Auditing Standard (AS) 2405, *Illegal Acts*.

<sup>3</sup> As noted in paragraph .06 of AS 2405, their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality.

<sup>4</sup> 15 U.S. Code § 78j-1(b).

<sup>5</sup> Additional discussion of our concerns and suggestions continues on page A2 of the appendix.

<sup>6</sup> AS 2110, *Identifying and Assessing Risks of Material Misstatement*.



- Consideration of evidence of legal and regulatory concerns, such as inspection of regulatory correspondence.
- An explicit requirement for auditors to consider how compliance risks and indicators of potential noncompliance can affect the risks of material misstatement, with guidance as necessary to support consistent implementation.

The touchstone of a risk-based approach to planning and performing an audit (which focuses on risk of material misstatement of the financial statements in the context of the applicable financial reporting framework) should be retained when considering how to enhance auditor responsibilities related to noncompliance, including when evaluating any potential expansion of auditor responsibilities with respect to laws and regulations that have “indirect” effects. While we support the Board’s exploration of potential changes, we believe there are important tenets that should be maintained:

- Management is responsible for identifying relevant laws and regulations — which drive important disclosures to comply with Regulation S-K (for example, in relation to the description of the company’s business, risk factors, and legal proceedings). Management, with the oversight of the audit committee, makes judgments in preparing its periodic filings about whether contingent liabilities that may arise as a result of noncompliance are probable and capable of being estimated<sup>7</sup> — often with significant input from internal and external counsel (who are considered company specialists in PCAOB standards).
- The auditor’s overall objective in an audit conducted in accordance with PCAOB standards is 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. An auditor’s understanding of the company and its environment helps to inform the auditor’s risk assessment, including consideration of how misstatements of the financial statements may occur and how likely it is that they will occur. With respect to noncompliance, the auditor’s focus in the context of the overall objective of an audit is on considering how risks of noncompliance may affect risks of material misstatement and, when noncompliance has been identified, whether its effects are adequately recognized and disclosed in the financial statements, and whether the company has taken timely and appropriate remedial action with respect to that noncompliance. This focus is in line with the shared goal of reliable financial reporting.
- A company’s own conclusions as to possible noncompliance (or an auditor’s communication of possible noncompliance that it has identified or become aware of) can prompt management and audit committees to take action. But a company is not required (or even expected) to resolve its consideration of all potential instances of noncompliance in advance of its periodic filing deadlines.
- The respective roles and responsibilities of management and auditors promote accountability, while respecting the fundamental principle of auditor independence, thereby contributing to the financial reporting ecosystem.
- Auditing standards must deal with uncertainty of outcomes, legal and regulatory, while providing a framework for the auditor to reach reasonable assurance as to the subject matter within the context of an orderly flow of information to investors through periodic filings.

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<sup>7</sup> In accordance with Financial Accounting Standards Board Accounting Standard Codification Subtopic 450-20, *Contingencies – Loss Contingencies*.



In designing systems of internal control, management may establish processes and controls aimed at identifying instances of potential noncompliance, determining whether noncompliance has occurred, and responding in an appropriate and timely manner, in addition to determining the effect on the financial statements (including the nature, timing, and extent of required disclosures both within and outside of the financial statements). The proposal recognizes this and would require auditors to obtain a deeper understanding of management's processes and controls around noncompliance. Focusing auditors on what management has put into place is consistent with the tenets we describe above in terms of the respective roles of management and auditors. However, it is important to recognize the nature and extent of processes and controls in place across the spectrum of public companies may reasonably and appropriately vary significantly, including by industry.

The Board's economic analysis notes a company may incur costs if it takes remedial actions to improve its ICFR as a result of the proposed amendments or seeks to mitigate the extent of substantive procedures that the proposed standard would require of its auditor by enhancing the company's own processes and controls over its compliance with relevant laws and regulations.<sup>8</sup> Care should be taken to avoid changes to auditing standards assuming or indirectly creating changes to management responsibilities. The following are observations based on our experience that are relevant for the Board to consider as it decides upon a way forward:

- Well-functioning governance and compliance systems come at a cost and help companies to comply with expansive and complex legal and regulatory requirements. Having a strong compliance program is a necessity for companies, especially those that operate in highly regulated environments.
- In the absence of regulatory requirements that prescribe specific approaches, companies make many judgments in establishing compliance programs, including considering their business objectives and strategies and the body of laws and regulations to which they are subject. Their compliance approach may vary based on the types of laws and regulations to which they are subject and the risks to the business of noncompliance (e.g., a company may form views on whether particular requirements apply, the nature of potential penalties, effects on their ability to operate, and other potentially significant consequences that may arise from noncompliance). We are not aware of a "one size fits all" framework for assessing the design or operating effectiveness of legal and regulatory compliance programs. Indeed, to the contrary, these frameworks are company specific and are developed in an environment that is complex, uncertain, and subjective.
- Compliance programs often evolve in response to changes in the regulatory environment, including a company's understanding of enforcement actions and priorities, in particular from an industry perspective. Such external influences may change a company's view as to the possible likelihood and magnitude of the effects of noncompliance and other elements of their economic analysis (e.g., in terms of where additional investment and monitoring may be appropriate or necessary).
- A well-functioning multidisciplinary team composed of various experts, such as lawyers, scientists, engineers, and accountants, is often key to maintaining compliance systems. The expertise is often drawn from local, national, and international areas of practice. Legal advice is often important to company decisions and can be facilitated under the policy protections of attorney-client privilege.

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<sup>8</sup> PCAOB Release 2023-003, page 78.



- Timely auditor engagement with audit committees and other committees of a company's board can mitigate the risks that noncompliance will become more widespread or consequential or not be effectively remediated. Leveraging the result of management's process, including what may have already been communicated to the audit committee, avoids duplication of efforts and allows the auditor to focus on matters that are expected to have a more significant financial impact.

There is likely a continuum with respect to how companies' compliance programs could be taken into account by the PCAOB in determining a way forward. Auditors benefit from understanding companies' compliance programs as they plan their audits, as compliance risks can affect the risk that the financial statements are materially misstated. How management responds to actual and potential noncompliance can also inform the auditor's understanding of whether sound integrity and ethical values, particularly of top management, exist and are understood. Accordingly, when management has taken steps to establish a compliance program, auditors could do more to understand the design and implementation of the company's program, including the judgments management has made in determining whether noncompliance has or may have occurred, how the noncompliance affects the current period financial statements, and whether disclosures are necessary. These types of expectations could be incorporated into auditing standards.

At the other end of the continuum are attestation engagements (including agreed-upon procedures, reviews, and examinations) that are performed today related to aspects of companies' compliance programs. For example:

- The SEC and PCAOB have taken action (including specific rulemaking) and made determinations about where auditors should concentrate their efforts on evaluating brokers' and dealers' internal control over compliance — resulting in a focus on financial responsibility rules as part of a separate attestation engagement supported by a management assertion. Notably, these engagements focus on only a narrow but important subset of the many rules that apply to brokers and dealers, with a focus on those rules that would most impact users. And the rules selected are ones that fall within an auditor's competencies (e.g., whether complete and accurate account statements are provided timely to customers or whether required reserves are maintained).
- An attestation engagement on a company's compliance risk management function may be performed that results in an examination of the design, implementation, and effectiveness of the compliance function. Such engagements require specialized expertise, including legal expertise and subject matter-specific expertise (e.g., in relation to environmental, health and safety, or consumer protection regulations). Even those engagements do not result in accountants reaching legal conclusions about whether noncompliance has occurred.

These engagements are necessarily separate from a financial statement audit and an audit of ICFR and require discrete planning and execution by those with appropriate competence, as they are performed for a different purpose.

### **Greater stakeholder engagement is needed**

We commend the Board for its ongoing efforts to modernize its standards and demonstrate how it is achieving the goals laid out in its *Strategic Plan 2022-2026*.<sup>9</sup> The policy questions about how best to meet the Board's mission of investor protection in the context of noncompliance are complex. The two dissenting Board members' concerns about clarity, scalability, and cost are likely to be shared not only by auditors, but also by preparers and audit committees. Significant disruption by not coordinating the

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<sup>9</sup> See our [response](#).



auditor's role with board, management, and third-party responsibilities could compromise reliable financial reporting and have other unintended consequences.

This initial comment period offered the first opportunity for stakeholders to consider the proposal and provide feedback for the Board's consideration. More public consultation and stakeholder engagement will be vitally necessary, in our view. We encourage an inclusive outreach program to assess how to proceed and to ensure the benefits and costs of its proposals are clearly considered, and we would look forward to participating in it. Outreach would give the Board insight into whether the resulting standard is capable of consistent implementation in a manner that serves the Board's investor protection mission and supports audit quality. Such outreach should also include a fulsome discussion about the role and competencies of auditors, the potential for the auditor's responsibilities to conflict with independence requirements, the legal consequences, and the likelihood that the unintended consequences articulated in the proposing release will occur (in particular the possibility that auditor responsibilities to address instances of noncompliance that are immaterial to the financial statements would unduly distract the auditor from other important audit areas).<sup>10</sup>

Further discussion and legal analysis is needed to ensure a final standard does not (1) result in auditors practicing law (which is not permitted under current state laws in the US and is similarly prohibited in other foreign jurisdictions) or acting in a capacity that is expected of management, or (2) unnecessarily undermine important concepts such as attorney-client privilege in areas less likely to relate to financial reporting.

The Board should consider public roundtables or similar mechanisms to discuss the feedback received and the Board's intended response in advance of issuing further proposals or standards. This would allow stakeholders to engage with the Board and each other to provide real-time input on the Board's response and alternative proposals. We also recommend field testing to validate and refine the Board's economic analysis.

### **The Board's objectives may be best advanced by facilitating a broader, multi-stakeholder approach**

Given the shared objectives of providing investors with decision-useful information, complementary actions by the SEC and FASB would likely be needed to achieve the objectives the PCAOB intends to achieve with the proposal and support its effective implementation. There are practical limitations to what the Board can achieve on its own, and additional actions by others are likely necessary for the Board to be successful in enhancing audit quality.

These additional actions by others — many of which would clearly fall outside the scope of a financial statement audit — would require significant deliberation to consider very complex issues related to their merits, costs, and practicality. The benefits of certain actions may be worthwhile for some, but not all, types of public companies (e.g., banking vs. other types of financial services such as mutual funds, manufacturing companies vs. retail companies). There may be lessons to be learned from US rulemaking related to broker-dealer management assertions and attestation requirements, mutual funds, and climate issues insofar as those regulations contemplate assurance on specific aspects of company disclosures outside the financial statements.

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<sup>10</sup> PCAOB Release 2023-003, page 85.



For example, to underpin the proposed standard as drafted, changes would need to be coordinated with other bodies (including those with regulatory or even legislative authority) to establish a cohesive approach that addresses the following:

- Management’s (with oversight of the board) responsibility for compliance with relevant laws and regulations and to provide management representations.
- Incremental management requirements to design and implement internal controls relating to compliance (and noncompliance) to enable auditors to meet the PCAOB’s expectations with respect to auditors identifying, evaluating, and communicating about noncompliance. In particular, management would need to form a view on what laws and regulations are “relevant” for purposes of the audit (i.e., those with which noncompliance could reasonably have a material effect on the financial statements).
- What evidence management would need to provide to auditors to support management’s determinations about compliance with relevant laws and regulations to enable auditors to evaluate the nature and validity of such determinations.
- How to resolve legal uncertainty and a threshold of reasonable assurance while coordinating with the practicalities of adequate timeliness in the communications to suit the periodic disclosure timelines for annual and interim financial statements, as well as, for example, securities offering and business combination disclosures.
- Auditor independence and objectivity, particularly with respect to requirements for management to prepare documentation and make judgments.
- Requisite auditor knowledge and capabilities in relation to a broader scope of laws and regulations (including in all important phases of the identification, evaluation, and communication processes).
- Effective audit committee oversight, including addressing familiarity on the part of audit committees and others with the purposes of the auditor communication (including appreciation of the needs of the financial statement users), and recognition that other committees of a company’s board may have responsibility for overseeing compliance with laws and regulations that do not have a direct and material effect on the determination of financial statement amounts.

The following are examples of other actions that could be explored to achieve a more holistic approach, subject to appropriate cost-benefit considerations:

- Changes to company responsibilities to monitor and address compliance, and additional guidance to explain the interaction of internal controls over compliance with companies’ obligations for maintaining books and records, disclosure controls and procedures, and ICFR, as well as management’s certifications.
- Requirements for a company to (1) more specifically describe how it considers risks of noncompliance and (2) disclose when noncompliance has been identified or is otherwise suspected but the potential future financial statement effects cannot be reasonably estimated (but may ultimately materially affect the financial statements).
- Specific compliance reporting (e.g., assertions or certifications) by companies to provide investors with insight into how management and audit committees approach their compliance obligations.





- Separate attestation by auditors on specified aspects of a company’s compliance program to enhance the credibility of these programs.
- Enhanced engagement between auditors and regulators (e.g., similar to what is prevalent in the banking industry).

Globally, regulators and standard setters have pursued different paths related to preventing and detecting noncompliance, including incremental management reporting on compliance beyond the financial statements, and increased auditor responsibilities to evaluate elements of management commentary and other matters outside of the financial statements. Accordingly, broader dialogue with regulators, policymakers, and standard setters (e.g., the International Forum of Independent Audit Regulators, the International Organization of Securities Commissions, the International Auditing and Assurance Standards Board (IAASB), the International Ethics Standards Board for Accountants (IESBA), the European Commission, the World Bank, the Organization for Economic Co-operation and Development, the American Bar Association) could also provide valuable perspectives to assist in determining how the auditor’s role could potentially evolve and what other actions would be necessary to support appropriate changes.

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In summary, we support building trust in society, we support investor protection, and we support the Board’s desire to enhance auditor responsibilities related to noncompliance and respond to concerns that have been raised by some investors. However, we do not support the changes that the Board has proposed. The approach taken in the proposal is largely unworkable for the reasons we describe in this letter and would not, in our view, advance the PCAOB’s objective of greater investor protection.

We value the Board’s commitment to inclusive outreach, and we stand ready to engage constructively to play our part in helping the Board develop practical ideas and facilitate a more fulsome dialogue to advance the PCAOB’s objectives. Please contact Wes Bricker ([wesley.bricker@pwc.com](mailto:wesley.bricker@pwc.com)), Kathryn Kaminsky ([kathryn.s.kaminsky@pwc.com](mailto:kathryn.s.kaminsky@pwc.com)), or Brian Croteau ([brian.t.croteau@pwc.com](mailto:brian.t.croteau@pwc.com)) regarding our submission.

Sincerely,

A handwritten signature in cursive script that reads "PricewaterhouseCoopers LLP".

PricewaterhouseCoopers LLP



## Appendix

This appendix provides additional details regarding where we support and where we have concerns with key aspects of the proposal, and, where possible, suggests actions that could be explored in response to those concerns.

### **We support an enhanced focus on the consideration of compliance risks in the auditor's risk assessment**

We support the Board's efforts to set out additional required risk assessment procedures through the changes it is proposing to AS 2110 and believe these changes would codify certain best practices into the standards. In particular:

- It is appropriate to prompt auditors to do more to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement and the company's risk assessment process — including how management approaches their responsibilities for complying with laws and regulations.
- Auditors may have a better basis for developing views on the potential for risks of material misstatement as a result of noncompliance where they understand management's processes for (1) preventing, identifying, investigating, evaluating, communicating, and remediating instances of alleged or suspected noncompliance, (2) receiving and responding to tips and complaints from internal and external parties (including through any whistleblower program), and (3) evaluating potential accounting and disclosure implications of noncompliance. These processes are ultimately the primary source of information about whether noncompliance has occurred, though the auditor may also become aware of additional instances of actual or suspected noncompliance through the performance of other procedures.
- Understanding changes to the company's objectives, strategies, and related business risks helps auditors identify business risks that could reasonably be expected to result in a material misstatement of the financial statements. A deeper understanding may help auditors better consider whether there is the potential for noncompliance (e.g., the auditor may consider whether incentives to win contracts or product approval, achieve aggressive sales targets or growth rates, or otherwise gain a competitive advantage could create circumstances where certain noncompliance is more likely to occur) and determine how that affects the auditor's judgments about risks of material misstatement.
- Developing an understanding of management's views as to which laws and regulations are significant in the context of the financial statements and other financial reporting requirements, as well as the company's ongoing operations, can better equip auditors to appropriately challenge management when it appears a law or regulation that could potentially have a significant impact has not been adequately considered. However, auditors themselves cannot be expected to identify all of the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, nor should they be expected to hold a greater proficiency with respect to legal compliance than is reasonable for accountants.
- Expanded inquiries of management, audit committees, internal audit, and in-house legal counsel could serve to make auditors aware of potential noncompliance on a more timely basis. In particular, inquiring whether correspondence exists with the company's relevant regulatory authorities regarding instances of noncompliance can help auditors understand the potential effects of noncompliance on the financial statements and engage in a dialogue with management about whether and, if so, how such matters may be disclosed. An additional focus on timely communication with external counsel on matters related to noncompliance, including ongoing investigations, may be warranted.



- Use of auditor specialists may be necessary, in particular to evaluate the work of the company’s specialist (which may include legal counsel or forensics specialists conducting any investigation), as well as to enable the auditor to conclude whether senior management has taken timely and appropriate remedial actions with respect to noncompliance.
- Revisions to the auditor’s initial risk assessment may be necessary depending on the outcome of company investigations or the resolution of noncompliance more broadly. Noncompliance that implicates senior management or the audit committee could be an indication of concerns with the integrity of management, tone at the top, and the company’s culture — all of which could indicate the auditor’s risk assessment needs to be revised or may ultimately result in a material weakness.

### **A different approach is necessary to determine the laws and regulations auditors should focus on in their risk assessments**

Our concerns with the proposal stem from the Board’s decision to significantly expand the auditor’s objective from detecting noncompliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts to include identifying whether there are instances of noncompliance with a broad range of laws and regulations that have or may have occurred.<sup>11</sup> To do so, the auditor would be required to identify those “laws and regulations with which noncompliance could reasonably have a material effect on the financial statements” and plan and perform procedures to identify whether there is information indicating noncompliance with those laws has or may have occurred.<sup>12</sup>

While it appears the Board intends auditors to exercise professional judgment and consider how the potential risks of noncompliance affect risks of material misstatement,<sup>13</sup> what is proposed is significantly disconnected from — and far more expansive than — the well-understood requirement in Section 10A for the audit to include procedures designed to provide reasonable assurance that “illegal acts that would have a direct and material effect on the determination of financial statement amounts”<sup>14</sup> would be detected.

Existing AS 2405 appropriately notes that companies 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.<sup>15</sup> Generally, these laws and regulations relate more to a company’s operations than to its financial and accounting aspects, and their financial statement effect is indirect. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Accordingly, there is presently no obligation to design procedures to detect illegal acts that would have only an indirect effect on the financial statements, and it is impracticable to expect auditors to achieve the same reasonable assurance threshold for these types of laws and regulations.

Notwithstanding the distinction between the two types of laws and regulations (those with direct and indirect effect on financial statement amounts), auditors currently are and should be expected to respond when they detect or otherwise become aware of information indicating that noncompliance (whether or not perceived to have a material effect on the financial statements) may have occurred, consistent with

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<sup>11</sup> Proposed AS 2405, paragraph .04(c).

<sup>12</sup> *Ibid*, paragraphs .04-.05.

<sup>13</sup> *Ibid*, paragraph .04(b).

<sup>14</sup> Paragraph .05 of AS 2405 notes: “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.... 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*.”

<sup>15</sup> AS 2405, paragraph .06.



Section 10A. Increasing the likelihood that auditors become aware of potential noncompliance with laws and regulations that may have an indirect effect on the financial statements is appropriate, as noncompliance could result in material penalties and fines.

However, we believe that the PCAOB's proposal would have the practical effect of incorporating compliance-oriented risk assessment, testing programs, and communication routines into audits conducted in accordance with PCAOB standards. What is proposed is more akin to a forensic audit (where the objective would be to examine and evaluate the company's financial records for evidence that fraud may have occurred and report on what the auditor has found) or assurance on a company's compliance risk management function (an examination of the design, implementation, and effectiveness of the compliance function). Such engagements require specialized expertise, including legal expertise and subject-matter specific expertise (e.g., in relation to environmental regulations, health and safety, consumer protection). Even those engagements do not result in accountants reaching legal conclusions about whether noncompliance has occurred. Although these types of engagements could certainly have significant benefits in particular circumstances, adopting a requirement for every company to engage their auditors to effectively perform such procedures on a broader range of laws and regulations would impose costs that would far exceed any benefit. For these reasons, we do not believe it is appropriate to extend the auditor's objectives and requirements in the manner proposed.

*Congress carefully crafted Section 10A to avoid concerns that are raised by the PCAOB's proposal*

Section 10A was the result of many years of negotiations, engagement, and significant debate across a wide spectrum of stakeholders. Originally commenced as a Congressional response to introduce additional auditor responsibilities to detect and report on fraud in the wake of the savings and loan crisis of the 1980s, Section 10A in its current form was ultimately added to the Securities Exchange Act of 1934 as part of the Private Securities Litigation Reform Act of 1995.<sup>16</sup> Over the course of multiple legislative sessions and hearings, some stakeholders expressed concerns that extending the scope of the auditor's responsibilities related to illegal acts too far would fundamentally change the role of the auditor. Others noted that the absence of a limitation on auditors' responsibilities around illegal acts could scope in a potentially vast body of relevant laws and regulations.<sup>17</sup> In particular, during Congressional hearings over one iteration of the proposed legislative measures introduced in 1990, the then General Counsel of the SEC stated the following: "Any decision to impose additional new requirements for early fraud detection involves striking a difficult balance between the benefits of finding fraud at an early stage and the costs to the capital formation process associated with new or extended procedures. This task is complex, as it requires careful judgments to weigh incremental benefits against costs and to define the types of problems that auditors may reasonably be expected to uncover during the course of an audit."<sup>18</sup>

Ultimately, Congress arrived at an approach that set out auditor responsibilities in a manner commensurate with auditors' competencies and what could be reasonably achieved in a financial statement audit. It placed the responsibilities of the auditor within a framework that retained management's core responsibility for financial reporting, including with respect to illegal acts. The Board's proposal, however, would dismiss that framework, including the years of diligent learnings that it took to arrive at that result, and instead expand auditors' responsibilities in exactly the ways that were thoughtfully considered and rejected in the decade-long legislative process, and are therefore contrary to Congressional intent. Accordingly, the auditing standards should retain the differentiated procedures

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<sup>16</sup> Reiss, Andrew W. (1997) "Powered by More Than GAAS: Section 10A of the Private Securities Litigation Reform Act Takes the Accounting Profession for a New Ride," *Hofstra Law Review*: Vol. 25: Iss. 4, Article 5. Available at: <http://scholarlycommons.law.hofstra.edu/hlr/vol25/iss4/5>

<sup>17</sup> *See id.*, at 28.

<sup>18</sup> *See* Hearing before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, House of Representatives, 101st Congress, 2d Session (August 2, 1990).



required in relation to noncompliance that would have a direct effect on the financial statements versus noncompliance that would have only an indirect effect.

*Clearly articulating how auditors determine which laws and regulations need to be considered is essential*

We have a number of concerns with requiring auditors to identify those laws and regulations “with which noncompliance could reasonably have a material effect on the financial statements” (hereafter referred to as “relevant laws and regulations”). As the proposing release notes, issuers currently identify and disclose material risks related to laws and regulations in periodic filings made under federal securities laws. It is not practicable to suggest that auditors would have the competency to make such an identification independently, nor is it appropriate. Requiring auditors to continue to do so on a recurring basis as laws and regulations (and their administrative interpretations) continue to evolve (and as the company’s business evolves, either organically or through mergers and acquisitions) essentially places the auditor in the role of a management function. Rather, we believe auditors could understand how management has determined relevant laws and regulations and apply professional skepticism in considering whether, based on the auditor’s risk assessment procedures and knowledge of the company’s business and industry, there may be other relevant laws and regulations that management has not identified or that have not been adequately considered.

Next, the concept as described in the proposal is overly broad and not adequately scoped. A lack of clarity as to how the auditor is expected to identify which laws and regulations would be relevant could cause significant confusion and likely inconsistent application in practice, which would not benefit audit quality. We find the guidance in the proposal insufficient and believe a better risk-based framework for determining relevant laws and regulations needs to be established in the final standard.

To appropriately focus auditor efforts, we suggest the Board consider an alternative approach. Auditors could be required to understand those laws and regulations identified by the company (or that the auditor becomes aware of in executing the audit), compliance with which may be fundamental to the operating aspects of the company’s business, its ability to continue its business, or to avoid material penalties. This approach acknowledges that noncompliance with certain types of laws and regulations, while having an indirect effect, could ultimately have a material impact if noncompliance occurs.<sup>19</sup> Auditor judgment about which laws and regulations are relevant should largely be based on an understanding of management’s processes to establish controls over compliance and monitor whether noncompliance has occurred.

A key tenet should be that the nature and circumstances of the company determine which laws and regulations would be relevant for purposes of the auditing standard. If the body of relevant laws and regulations is not sufficiently narrowed, and clearly identified, the Board risks auditors spending unnecessary time and effort seeking out noncompliance with laws and regulations that is unlikely to result in a material misstatement. A more balanced approach that requires auditors to understand how management considers whether compliance risks result in risks of material misstatement, and also requires communication with audit committees to confirm that understanding, could alleviate concerns over unnecessary cost.

Through enhanced risk assessment procedures, including inquiry and review of correspondence with regulatory authorities, auditors may become aware of more instances of potential noncompliance that would require a response, including communicating with management and audit committees and evaluating the effect on the financial statements (including disclosures). This could result in meaningful incremental effort while not ignoring concerns regarding what is reasonable to expect the auditor to do with respect to detecting noncompliance with laws and regulations that have only an indirect effect on the financial statements.

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<sup>19</sup> This approach is consistent with revisions made in recent years to the IAASB, IESBA, and AICPA standards.



*A framework is needed to help auditors evaluate management’s determination of relevant laws and regulations*

The October 2017 IAG Working Group Recommendations highlighted the IESBA’s changes to international ethics requirements related to noncompliance, which resulted in the establishment of a framework to guide professional accountants in what actions to take in the public interest when they become aware of noncompliance or suspected noncompliance. The IESBA standard states that “the [auditor] is expected to apply knowledge, professional judgment and expertise, but is not expected to have a level of knowledge of laws and regulations that is greater than which is required to undertake the engagement.” Notably, the IESBA did not expand auditors’ obligations for identifying noncompliance. Rather, they highlighted additional examples of laws and regulations that may be relevant. These include fraud, corruption, and bribery; money laundering; securities markets and trading; banking and other financial products and services; data protection; environmental protection; and public health and safety.

We recommend that the Board develop an appropriate framework to enable auditors to evaluate management’s determination of relevant laws and regulations. Additional examples could be developed based on the existing US regulatory framework to explain what is meant by compliance being “fundamental to the operating aspects of the company’s business” in the context of specific industries. Engagement with the SEC and other regulatory and enforcement bodies may offer insight as to when noncompliance would have the most significant effects on companies.

Finally, further guidance in the standards could help auditors connect what they learn from performing risk assessment procedures and determinations about whether risks of material misstatement exist either at the financial statement level or the assertion level (or both). For example, instances of noncompliance, and a lack of appropriate management remediation, could raise questions about the integrity or conduct of the company’s directors, senior management, or owners, that could result in a financial statement level risk. Instances of noncompliance could also raise doubts about the company’s ability to continue as a going concern, for example if the company could lose significant operating licenses or fail to meet regulatory solvency requirements.

**Requirements to identify noncompliance should be practicable**

The auditor’s overall objective in an audit conducted in accordance with PCAOB standards is 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. Setting an objective in the auditing standards “to identify and evaluate information indicating that noncompliance has or may have occurred” could be read as implying that auditors will be able to find all information indicating that noncompliance has occurred. While this does not appear to be the PCAOB’s intent, we believe further clarification to the requirements — and more guidance as noted in the previous section — is necessary in moving forward. Notably, in making changes to its auditing standards as part of its Clarity project, the IAASB concluded that it would be inappropriate to suggest that management is capable of identifying all instances of noncompliance.<sup>20</sup> The same is true for auditors.

In the IAASB and AICPA standards, differing requirements are specified for each category of laws and regulations. The auditor’s risk assessment — and the overarching requirement to obtain sufficient appropriate audit evidence that financial statement amounts are not materially misstated — determines the nature, timing, and extent of procedures related to direct laws and regulations. For those relevant indirect laws and regulations, the auditor is required to perform procedures that may identify instances of noncompliance. These procedures include inquiries of management and audit committees about whether

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<sup>20</sup> See the IAASB’s Basis for Conclusions at <https://www.iaasb.org/publications/basis-conclusions-isa-250-redrafted-consideration-laws-and-regulations-audit-financial-statements>.



the company is in compliance with such laws and regulations and inspecting correspondence with the relevant licensing or regulatory authorities.

The expanded procedures as contemplated by the changes proposed to AS 2110 generally appear reasonable and risk-based and may increase the likelihood that auditors will become aware of potential noncompliance. But the Board has not articulated clear expectations about the nature and extent of any additional procedures that need to be performed “to identify whether there is information that noncompliance has occurred,” including how those procedures may or may not be linked to the auditor’s risk assessment. Given the interaction with the measurement and disclosure criteria (e.g., Accounting Standards Codification Topic 450, *Contingencies*), it may be difficult to expressly link risks of noncompliance to risks of material misstatement before noncompliance occurs — unless the company has a history of noncompliance. Additionally, it is inappropriate to suggest that the auditor would be able to search for all information indicating whether noncompliance has occurred, or that the auditor would design procedures similar to what would be expected for the purpose of obtaining reasonable assurance in relation to laws and regulations with direct and material effect on the determination of financial statement amounts.

Engaging with stakeholders, including investors, to understand their expectations relating to which matters auditors should have known (e.g., in the context of the types of highly publicized matters cited by Board members in their public statements) will help the Board consider an appropriate way forward. Additional guidance could then be developed to explain what types of procedures (beyond inquiry) might be expected for the purpose of identifying information indicating noncompliance has or may have occurred in accordance with paragraph .05(c) of AS 2405.

In particular, more consideration is needed on the interaction between (1) what the auditor learns as part of understanding management’s processes for (a) preventing, identifying, investigating, evaluating, communicating, and remediating instances of noncompliance, and (b) receiving and responding to tips and complaints from internal and external parties; (2) how auditors consider the results of inquiries about noncompliance as set out in paragraph .56 of AS 2110 and other information obtained in accordance with paragraph .11 of AS 2110; and (3) what additional procedures would be required to seek out additional information to identify potential instances of noncompliance. The nature and extent of such procedures would need to take into account the variety of, and differences in, the laws and regulations to which a company may be subject. It is reasonable to expect auditors to consider whether the results of other procedures performed to respond to the assessed risks of material misstatement contradict information provided by management, audit committees, and others obtained as a result of expanded inquiries or otherwise indicate that noncompliance has occurred.

### **Requirements addressing the auditor’s responsibilities to evaluate potential noncompliance need to be scalable and take into account management’s processes**

The Board acknowledges that many companies have ethics and compliance programs designed to effectively resolve the large majority of minor compliance matters.<sup>21</sup> The proposal would require enhanced risk assessment procedures to understand these programs. However, it is not clear how the Board believes auditors should take these programs into account. Instead, it appears that matters already identified by the company would be considered “information indicating that noncompliance has or may have occurred,” and the auditor would be expected to (1) obtain an understanding of the nature and circumstances of any such noncompliance and (2) determine whether it is likely that any such noncompliance has occurred — regardless of whether the effect of such noncompliance is perceived to be material to the financial statements.

Consistent with Section 10A, this level of effort is appropriate to address potential noncompliance with respect to laws and regulations with a direct and material effect on the determination of financial

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<sup>21</sup> PCAOB Release 2023-003, page 85.



statement amounts. Auditors are required to include procedures designed to provide reasonable assurance of detecting noncompliance with those laws and regulations because of their underlying nature. Requiring the auditor to understand noncompliance with those laws and regulations regardless of whether the effect of such noncompliance is perceived to be material to the financial statements is appropriate so that auditors do not prematurely conclude there are no material effects on the financial statements.

As noted in the previous section, however, it is impractical to expect the same level of effort for other laws and regulations, particularly if management's process has already considered the potential effect on the financial statements. The proposing release notes the Board "do[es] not believe that auditor responsibilities to address instances of noncompliance that are immaterial to the financial statements would unduly distract the auditor from other important audit areas."<sup>22</sup> We do not agree with this view and believe changes are necessary. While Note 2 to paragraph .07 of proposed AS 2405 notes the auditor's procedures involve the application of professional skepticism, the auditor should also be permitted to exercise professional judgment in determining how to respond. As drafted, it is unclear how materiality may influence the auditor's selection of those procedures. Further consideration of the impact of the proposed requirements related to evaluating noncompliance is necessary before moving forward. For example, more specific responses may be necessary in circumstances when the auditor detects the noncompliance, as this may indicate management's processes are not effective or other concerns with management integrity.

We are also concerned that the approach set out in paragraphs .07-.15 of proposed AS 2405 could have unintended consequences that could detract from audit quality. Furthermore, the approach does not take into account what we believe is leading practice when noncompliance is identified or suspected, or the fact that management is responsible for determining the effects of noncompliance. We note the following:

- The placement of paragraph .07 suggests that the auditor would be required to investigate potential noncompliance and determine whether it is likely that any such noncompliance occurred, and communicate the results of the evaluation to the audit committee. This potentially places auditors in the role of management, including being seen as giving legal advice.
- While paragraph .08 provides an example of procedures that may be performed, it is likely most relevant for auditors to first engage in a dialogue with the appropriate level of management to obtain an understanding of the potential noncompliance, including whether management has already commenced an investigation or communicated with the audit committee.

There is a risk that an auditor may "tip off" management in certain circumstances as a result of the proposed requirement for the auditor to communicate as soon as practicable, which the release notes may be prior to the completion of the auditor's evaluation of the information indicating noncompliance has or may have occurred. Additionally, early communication, or communication about matters that are unlikely to ever have material effect on the financial statements, risks diverting audit committees' attention from other more important matters.

- While Section 10A requires the auditor to "determine whether it is likely that an illegal act has occurred" and "the possible effect on the financial statements," auditors depend on legal judgment from the company's counsel to do so. We anticipate that the frequency of the need to obtain a legal judgment would increase given the proposed change in the scope of laws and regulations vis-a-vis the auditor's competencies. The proposal suggests auditors may need to engage their own legal counsel, rather than use the work of management's counsel as audit evidence (i.e., use the work of a management specialist as defined by PCAOB standards). In some circumstances this may be appropriate, but generally we expect that obtaining evidence from the company's in-house and external counsel (and evaluating the relevance and reliability of that evidence) is likely to be

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<sup>22</sup> PCAOB Release 2023-003, page 85.





sufficient, as is the case with evidence obtained from other management experts and assessed under AS 1105, Appendix A.

- There may be instances when management’s investigations or remedial actions are ongoing or planned at the time the auditor is expected to issue the audit report (or conclude an interim review). Instances of noncompliance may come to the auditor’s attention close to the time of periodic filings (including when the company has acquired a business). It is important for management to first form a view about whether the financial statements are materially misstated, including whether any disclosures are required by the applicable financial reporting framework, and for the auditor to then evaluate these judgments prior to the issuance of the financial statements. However, it is not feasible to suggest that the auditor could be satisfied that all identified or suspected noncompliance is detected and fully resolved, including completion of all remedial actions.

The prescriptive nature of the proposed requirements would also have an impact on the auditor’s documentation. The proposed changes to AS 1215<sup>23</sup> are likely to be particularly onerous. Auditors should be able to exercise professional judgment in determining the nature and extent of documentation needed depending on factors such as the nature of the matter and whether it was identified by management or the auditor. As an example, there may be a significant number of tips and complaints recorded as part of the company’s whistleblower program and other monitoring. Together with the inquiries proposed to be required by AS 2110 of management, audit committees, and internal auditors, this may result in a significant volume of information that would need to be evaluated and resolved. The proposed changes in AS 1215 could be read as implying that auditors may need to retain the full record from the company or otherwise replicate such documentation.

### **Applicable financial reporting requirements drive when the effects of noncompliance need to be disclosed**

We are concerned that the discussion in the proposing release that the changes “will promote audit quality by ensuring that material effects of noncompliance are appropriately presented, and in so doing, the standards promote investor protection”<sup>24</sup> could be misinterpreted if not clarified.<sup>25</sup> The consequences of noncompliance on the financial statements and other information included in periodic filings are grounded in requirements established by the FASB or IASB (e.g., in terms of the accounting and disclosure requirements for loss contingencies and going concern) and the SEC (e.g., in terms of the material effects that compliance with government regulations, including environmental regulations, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries; legal proceedings; and risk factors).<sup>26</sup>

As noted in paragraph .10(b) of AS 2405, the auditor’s determination of the possible effect of any identified noncompliance on the financial statements includes consideration of whether the criteria for recognition or disclosure is met related to any potential contingent monetary effects (and disclosure

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<sup>23</sup> AS 1215, *Audit Documentation*.

<sup>24</sup> PCAOB Release No. 2023-003, page 29.

<sup>25</sup> It is unclear how the PCAOB believes proposed changes to the concept of “fair presentation” as set out in proposed AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*, would apply in the context of disclosures about noncompliance in cases when management determined the potential effects of noncompliance did not meet the thresholds for disclosure in accordance with US GAAP. In our [response](#) to the PCAOB’s AS 1000 proposal, we expressed concern that the PCAOB was suggesting that auditors could override management’s well-reasoned judgment as a result of changes proposed to existing requirements addressing fair presentation.

<sup>26</sup> Such disclosure can be voluminous, and may vary based on the nature of a company’s business. For example, registrants are required to include a discussion of the material factors that make an investment in the registrant or offering speculative or risky. In a review of the most recently filed Forms 10-K for the top 50 Fortune 500 companies, we note an average of 29 risk factors disclosed, with an average of 13.5 pages dedicated to this discussion.



necessary in the current period financial statements). However, even with enhanced requirements for the auditor to seek out information indicating noncompliance has occurred, the effects of identified noncompliance may not be known for some time, and therefore no disclosure may be necessary. As acknowledged in extant AS 2405, the determination of whether a particular act results in an illegal act may have to await final determination by a court of law or the conclusion of a regulatory proceeding. It is therefore likely that many instances of noncompliance, even if they may ultimately result in a material effect to the financial statements in the future, would not meet the threshold for disclosure in accordance with the applicable financial reporting framework in the period in which the noncompliance was initially identified.

In future reporting periods, to the extent there are ongoing investigations or other pending actions related to previously identified noncompliance, we anticipate the need for auditors to further consider whether the criteria for recognition or disclosure of any potential contingent monetary effects are met. Guidance to this effect in the final standard may be helpful to promote consistency in practice.

**Additional auditor focus on information disclosed outside the financial statements may be appropriate, but changes should not be made in isolation**

The proposing release notes the following:

The effects of noncompliance on the amounts and disclosures in the financial statements includes considerations about whether financial statements properly reflect fines, penalties, or other potential contingent monetary effects or require additional disclosure necessary to make the financial statements not misleading. *For example, if noncompliance with a particular law creates a contingency or significant unusual risk associated with material revenue or earnings, that information is required to be considered for disclosure by management.*<sup>27</sup>

When the possible effects of noncompliance do not meet the thresholds for disclosure in the financial statements in accordance with applicable GAAP, there may be disclosures required to comply with SEC requirements (e.g., those that address management’s discussion and analysis of financial condition and results of operations and other topics referred to in the previous section). When it is likely noncompliance has occurred, the proposed standard would require auditors to perform additional procedures to determine whether the likely noncompliance 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.<sup>28</sup>

Discussion in the proposing release suggests the Board views this proposed requirement to be consistent with existing auditor obligations under AS 2710.<sup>29</sup> We do not agree. As drafted, the proposal directly conflicts with the fundamental premise in AS 2710 that the auditor’s responsibility with respect to information in a document does not extend beyond the financial information identified in the auditor’s report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document.<sup>30</sup> Specifically, the example on page 45 of the proposing release could imply that auditors are required to perform procedures related to key performance metrics (or prospective financial information). Although the Board may believe disclosures in other information may warrant additional auditor attention when noncompliance is identified, we do not believe changes should be made in isolation to expand the auditor’s responsibilities with respect to other information. Rather, a more fulsome consideration may be necessary to determine whether AS 2710 should be modernized or enhanced in light

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<sup>27</sup> PCAOB Release No. 2023-003, page 44 (emphasis added).

<sup>28</sup> AS 2405, paragraph .09(b).

<sup>29</sup> AS 2710, *Other Information in Documents Containing Audited Financial Statements*.

<sup>30</sup> AS 2710, paragraph .04.



of the increasing disclosure requirements in periodic filings and the likely expectation gap that exists vis-a-vis the current requirements related to reading and considering other information.

### **The proposal does not clearly articulate the interaction with AS 2401<sup>31</sup> in relation to fraud**

It is management's responsibility to design and implement processes and controls to prevent, deter, and detect fraud. The auditor's responsibilities in relation to fraud are clearly articulated in AS 2410: auditors consider risks of material misstatement related to two specific types of fraud — fraudulent financial reporting and misappropriation of assets — and appropriately plan and perform procedures to respond to assessed fraud risks. PCAOB standards require specific actions whenever the auditor has determined that there is evidence that fraud may exist, including bringing such matters to the attention of an appropriate level of management and, where necessary, the audit committee.

We agree in principle that the response to identified or suspected fraudulent financial reporting or misappropriation of assets should be similar to the expected response to noncompliance — and the response should take into account the nature of the act and the circumstances in which it has occurred. However, we do not believe the implications of including fraud in the definition of noncompliance, and the impact of expanding the definition of fraud,<sup>32</sup> have been adequately considered or explained in the proposing release, including the economic analysis. It is also not clear whether AS 2405 would require the auditor to perform additional risk assessment procedures related to fraud beyond what is required by AS 2401 and AS 2110.

Finally, the Board has not articulated whether it believes auditor performance in relation to fraud would change significantly as a result of this proposal, and what incremental changes are also being considered as part of the Board's mid-term standard setting project related to fraud. We suggest the Board take a more holistic approach to provide clear direction about the auditor's responsibilities related to different types of fraud and noncompliance. For example, more detailed guidance explaining the interaction between AS 2401 and AS 2405 would be helpful.

### **The proposal raises legal concerns that are not adequately addressed**

The Board's proposal raises sensitive questions about the impact that expanded auditor obligations involving noncompliance would have on attorney-client privilege, the work product doctrine, and other legal privileges or principles that shield confidential information from disclosure (e.g., professional secrecy obligations in some civil law jurisdictions). Attorney-client communications are generally protected from disclosure to encourage the free, unhindered, transparent flow of discussion and advice between a client and its attorney. It is also well understood that disclosure to a third party of privileged communications may waive the privilege, under certain circumstances, whether that disclosure is voluntary or involuntary. Issuers' reluctance to risk waiving privilege, and their counsel's obligation to protect the privilege, have always been in tension with auditors' obligations to obtain sufficient appropriate audit evidence in the course of the audit, particularly when there are known instances of suspected noncompliance. The Board's proposal, if adopted, would exacerbate this tension as a result of the substantially expanded volume and breadth of information that issuers, their employees, and their agents would be required to provide to auditors regarding potential or suspected noncompliance, especially as it relates to areas that are less likely to have financial reporting implications.

Furthermore, certain proposed amendments would essentially require auditors to conduct their own investigations to assess whether noncompliance is likely to or has occurred, including by gathering audit evidence through interviews or other investigative techniques of the company's employees or their agents.

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<sup>31</sup> AS 2401, *Consideration of Fraud in a Financial Statement Audit*.

<sup>32</sup> Page 4 of PCAOB Release 2023-003 notes that the definition of "noncompliance with laws and regulations" includes both fraud as defined in paragraph .05 of AS 2401 and all other types of fraud, such as non-scienter based fraud.



Because that work would be conducted by accountants and not attorneys, courts may conclude that legal privilege would not apply, depriving the client of the privilege (and other legal) protections that would apply if the work was instead performed by the client's attorneys. Although there is a brief reference in the Economic Impacts section of the Board's proposing release to attorney-client privilege, the Board has not adequately addressed the potential issues regarding privilege, which could have far-reaching unintended consequences. In addition, since the Board's proposal would essentially require auditors to perform inquiries and activities, make findings, and draw conclusions about potential legal or regulatory transgressions that typically require the expertise and skills of experienced legal practitioners, the Board's proposal also raises questions regarding whether certain proposed auditor obligations would constitute the practice of law. The proposing release does not delve into how the proposed new obligations for auditors may intersect with laws (both domestic and foreign) on the unauthorized practice of law.

The proposing release notes that the proposed definition of noncompliance includes acts or omissions from, among others, persons or entities acting within the scope of an agency relationship with the company.<sup>33</sup> It is not practicable to expect auditors to detect every potential instance of noncompliance at the company, but it is even less reasonable to expect them to detect all noncompliance by agents. That would require auditors to not only understand and apply agency laws, but also potentially perform procedures to detect noncompliance by agents whose employees, systems, and information the company may not control. The proposal does not articulate the Board's view on who may meet the definition of an agent (e.g., parties such as service organizations, investment advisors, custodians), nor acknowledge the potential inability for auditors to obtain information about noncompliance from these parties.

### **Other concerns**

There are other areas in the proposal we believe need to be reconsidered or, at a minimum, better articulated to promote consistent interpretation.

- Reference to senior management — AS 2201 notes that, for purposes of evaluating indicators of potential material weaknesses, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Sarbanes-Oxley Act as well as any other members of senior management who play a significant role in the company's financial reporting process.<sup>34</sup> Because the proposed standard references procedures related to compensation arrangements of senior management and presumptions when noncompliance involves senior management, similar guidance about the definition of senior management for these purposes is essential.
- Reading publicly available information about the company — The proposal does not define the concept of "publicly available" or acknowledge there might be a significant amount of information available (in particular from sources outside the entity). We agree in principle with requiring auditors to read company-issued press releases and a company's official social media accounts. However, auditors should be permitted to exercise professional judgment in determining what other publicly available information would be "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."<sup>35</sup> As an example, it is likely impracticable to require auditors to obtain all communications from executive officers (including their social media accounts) or all analyst reports, but information such as short seller reports may be relevant. It may also be difficult for auditors to ascertain the completeness of publicly available meetings with investors or other ratings agencies. The PCAOB should better explain the purpose of the proposed requirement and how it could be reasonably accomplished. We note that the proposal does not address the

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<sup>33</sup> PCAOB Release 2023-003, page 24.

<sup>34</sup> AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, paragraph .69, footnote 14.

<sup>35</sup> AS 2110, paragraph .04.



potential costs or scalability of elevating what was previously deemed a consideration to a requirement.

- Interim reviews — We are concerned that the proposed changes to AS 4105,<sup>36</sup> including the reference to AS 2405, suggest that auditors would need to evaluate and fully resolve any potential noncompliance identified during a quarter prior to a company's periodic filing. We do not believe this is practicable considering the potential nature of noncompliance and short financial reporting deadlines. We suggest that the Board consider changes related to noncompliance more holistically within its interim project addressing the need for revisions to AS 4105.

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<sup>36</sup> AS 4105, *Reviews of Interim Financial Information*.