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Phoebe W. Brown, Secretary
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Public Company Accounting Oversight Board
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PCAOB proposing release on *Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments* (PCAOB Release No. 2023-003; Docket Matter No. 051)

Dear Ms. Brown:

Ernst & Young LLP is pleased to submit to the Public Company Accounting Oversight Board (PCAOB or Board) its comments on the Board's proposal *Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments (NOCLAR)*.

We generally support the PCAOB's efforts to modernize its standards and clarify the responsibilities of auditors with respect to noncompliance with laws and regulations, including fraud, due to changes in the auditing environment since the PCAOB adopted the standards of the American Institute of Certified Public Accountants (AICPA) in 2003 on an interim basis. We believe a clear, comprehensive and actionable standard addressing auditors' responsibilities regarding a company's noncompliance with laws and regulations, including fraud, would reinforce audit quality.

We value the due process that the PCAOB provides in its standard setting. We seek to provide the Board and its staff with constructive input based on our technical review of proposals and understanding of operational implications. We have carefully reviewed the PCAOB's NOCLAR proposal.

We support the following aspects of the proposal:

- ▶ Expanding the definition of noncompliance with laws and regulations in proposed Auditing Standard (AS) 2405.01 to include "fraud as described in paragraph .05 of AS 2401, *Consideration of Fraud in a Financial Statement Audit*"
- ▶ Expanding, subject to the changes necessary based on our concerns raised below, the requirement for auditors to perform increased risk assessment procedures, as well as additional substantive procedures on identified laws and regulations
- ▶ Amendments to proposed AS 2110: *Identifying and Assessing Risks of Material Misstatement* paragraphs .05, .13, .15, .26, .49, .54, .56, .57 a, b, c, d (1) and d (2) and .58

We concur with the statement of Board Chair Erica Y. Williams that “[w]hen an auditor signs an audit opinion on a company’s financial statements, they are signing their names to the fact that the financial statements ‘present fairly, in *all* material respects,’ the company’s financial position and results of operations.”¹

However, we have significant concerns about several aspects of the proposal, and we agree with Board member Christina Ho, who said “[t]his 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.”²

We encourage the PCAOB to avoid making changes to the standard that would broaden the responsibilities of auditors to encompass matters well beyond conducting audits that result in the preparation and issuance of informative, accurate and independent auditor’s reports. In our view, certain key provisions of the proposal would go beyond the auditor’s obligation to provide reasonable assurance over financial statements. We do not believe that the obligations of auditors with respect to noncompliance with laws and regulations should be more stringent than auditors’ obligations with respect to other aspects of the financial statement audit. The level of assurance sought by the proposal would be closer to absolute assurance, which would be inconsistent with the objectives of an audit.

Further, we have concerns about whether such a level of assurance would be operational and could be achieved consistently, which would likely exacerbate the expectation gap between users of the financial statements and auditors. We are also concerned that auditors would be drawing conclusions under a different threshold as provided by the proposal than company management. US GAAP requires management to apply the guidance provided within Accounting Standards Codification (ASC) 450 of the Financial Accounting Standards Board (FASB) for these purposes, which would likely lead to different conclusions being reached by management and the auditor under the proposal. Accordingly, we have identified certain portions of the proposal that we believe require additional discussion, analysis and revision to achieve a modernized standard that auditors would be able to consistently interpret and apply to improve and promote audit quality.

We identified several significant changes that we recommend that the PCAOB incorporate in any final standard. These changes would support the PCAOB in its efforts to modernize these standards while avoiding an undue expansion of the scope of external audits for public companies. Our recommended changes would not only benefit investors, audit committees and other stakeholders but also would enable auditors to operationalize a final standard that would improve audit quality and drive consistent interpretation of the responsibility of auditors.

¹ Refer to Statement on Proposed New Standard Regarding Noncompliance with Laws and Regulations made by Erica Y. Williams on 6 June 2023.

² 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 6 June 2023.

Introduction and objectives of proposed AS 2405

Introduction – Proposed AS 2405.01

We recommend clarifying proposed AS 2405 to state that auditors would be required to identify laws and regulations for which noncompliance would be “probable” of having a material effect on the financial statements, rather than “could reasonably have” a material effect on the financial statements as proposed by the PCAOB, in order to drive consistency with the accounting standards. “Probable” is a term currently used in the FASB ASC Topic 450, and it is broadly understood by investors, preparers and auditors. We note that the term “could reasonably have” is an undefined threshold that likely would create confusion and require the consideration of a broader set of laws and regulations than required today under GAAP, as further discussed later in this letter.

We are proud of our public interest role as independent auditors of public companies. However, we are concerned that some may misinterpret the proposed reference to auditors having a “fundamental obligation to protect investors” and “that obligation governs this standard” in proposed AS 2405. This language could create the misimpression that auditors are not only permitted to but are expected to diverge from following auditing standards in situations where they feel it would be warranted to further investors’ interests. To address this, we suggest the following changes:

2405.01 Auditors have ***responsibilities to conduct an audit*** ~~a fundamental obligation to protect investors~~ through the preparation and issuance of informative, accurate, and independent auditor’s reports ***under the standards of the PCAOB. This includes*** ~~and that obligation governs this standard~~ ***the obligation*** to identify and evaluate information indicating that noncompliance with laws and regulations, including fraud, has or ***is probable of occurrence*** ~~may have occurred~~ and make appropriate communications to management and the audit committee about such information.

Objectives – Proposed AS 2405.04

As noted above, one of the concerns we have with the proposed standard is the extent to which the objectives appear to expand an auditor’s responsibility. While we support the Board’s efforts to modernize its standards, the proposal goes beyond existing PCAOB standards, which specifically require 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.

Accordingly, we believe the objectives of proposed AS 2405 should be revised to clarify that the auditor is not, and cannot be, expected to assume responsibility for, or duplicate, the company’s overall compliance process aimed at preventing and identifying noncompliance with laws and regulations. Without this clarification, we believe the proposal would significantly expand the auditor’s responsibilities and result in the auditor performing an audit of a company’s compliance with laws and regulations, which would far exceed the reasonable assurance threshold.

On this point, we agree with the statement of Board member Duane DesParte: “I believe it unreasonably and at great cost expands the scope of the audit to incorporate extensive new compliance attestation procedures and will require legal acumen and expertise well beyond the auditor’s core competency.”³

Proposed amendments related to a company’s noncompliance with laws and regulations

Auditor’s independent assessment – Proposed AS 2405.05-2405.06

We believe it is essential to eliminate the proposed requirement for the auditor to perform an independent assessment of all laws and regulations the company is subject to, for purposes of identifying those for which noncompliance could reasonably have a material effect on the financial statements. As currently acknowledged in extant AS 2405.06,⁴ auditors do not have a sufficient basis for recognizing *possible violations* of laws and regulations whose effect may only be indirect on the financial statements.

Accordingly, it would be reasonable to conclude that auditors have even less ability to *identify* all potential laws and regulations and then perform a risk assessment process to determine which laws and regulations could be material to the financial statements in the event of noncompliance.

On the implications of this point, we agree with the view expressed by Ms. Ho, who stated “[t]o identify the laws and regulations with which noncompliance could reasonably have a material effect on financial statements, an auditor must first identify all the laws and regulations applicable to the public company. It is this threshold requirement which causes me the greatest concern and for which the proposal does not seem to fully address.”⁵ To illustrate this point, consider that there were over 93,000 new federal laws and regulations enacted from 1995 through 2016.⁶ Further, there are in excess of 60,000 different sections of the California Code of Regulations in effect as of May 2022.⁷ While as a practical matter many of these may not apply to a particular company and/or could not reasonably have a material effect on the financial statements in the event of noncompliance, an evaluation would still have to be performed to make that determination. This demonstrates the potential significant effort that may be necessary to identify relevant laws and regulations under the PCAOB’s proposal.

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 Duane M. DesParte on 6 June 2023.

⁴ AS 2405 refers to as “indirect” laws and regulations when it states “[g]enerally, 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.”(emphasis added)

⁵ 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 Board member Christina Ho on 6 June 2023.

⁶ From Forbes.com, *How Many Rules And Regulations Do Federal Agencies Issue*, by Clyde Wayne Crews Jr., on 15 August 2017.

⁷ From Californiaglobe.com, *How Many Total Regulations Are in California’s Code of Regulations?*, by Evan Symon on 6 August 2023.

In addition, the proposal appears to require the auditor to identify and evaluate noncompliance with laws and regulations beyond what is required of management under the SEC's securities laws. For example, we note that SEC staff guidance⁸ states that compliance with laws and regulations that are directly related to the preparation of the financial statements are within the scope of a registrant's internal control over financial reporting (ICFR). It also notes that a registrant's assessment of its disclosure controls and procedures must consider compliance with other laws, rules and regulations and should include "assessing whether the registrant (1) adequately monitors such compliance, and (2) has appropriate disclosure controls and procedures to ensure that required disclosure of legal or regulatory matters is provided." Without further clarifications with respect to the auditor's responsibilities relative to that of management, we are concerned that creating an obligation for the auditor to identify all laws and regulations, and the process of evaluating their relevance to the company and its potential effect on the financial statements, would have the result of auditor's being put in a position to effectively perform a management function.

Laws and regulations that have an indirect effect on the financial statements – Proposed AS 2405.05-2405.06

We understand the Board's rationale for eliminating the distinction between laws and regulations for which noncompliance would have a direct and material effect on the financial statements and those for which noncompliance would have an indirect effect. Careful consideration and evaluation is required for how broadly this should apply as there is an expansive range of laws and regulations that are operational in nature and, if breached, could potentially have a material impact on a company's financial statements, even if the likelihood of a breach is remote. It would be a challenge and not operable for auditors to assess and evaluate the universe of laws and regulations that have an indirect effect on the financial statement as currently defined in the proposal.

We believe it is instructive to consider the history of Section 10A of the Securities Exchange Act of 1934 (Section 10A), which was developed through significant deliberation and due process and reflected feedback from various stakeholders in the financial reporting supply chain. For example, the 1990 proposal of Section 10A sought to require the auditor to perform procedures to obtain "reasonable assurance of detecting illegal acts that would have a material impact on the issuer's financial statements by reviewing compliance with laws and regulations which, if violated, could materially affect the issuer's financial statements or operations."⁹ In reaction to this proposed requirement, the then SEC General Counsel, James R. Doty, expressed concern regarding the breadth of this proposal by noting the "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."¹⁰ We have the same concerns today with the breadth and scope of the PCAOB's proposed standard, and we are concerned that the proposal does not fully recognize or address the impact of those concerns.

⁸ See SEC Frequently Asked Questions, "Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports (6 October 2004) at <https://www.sec.gov/oca/controlfaq1004>

⁹ "Hearing before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce House of Representatives," *One Hundred First Congress Second Session*, August 1990, Serial No. 101-196, p. 9.

¹⁰ "Hearing before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce House of Representatives," *One Hundred First Congress Second Session*, August 1990, Serial No. 101-196, p. 92.

In addition to our concern over the operability challenges if the distinction between laws and regulations that have an indirect and direct effect on the financial statements is eliminated, we suggest the Board revise the scope of the proposal so that auditors would be required to identify laws and regulations for which noncompliance would be “probable” of having a material effect on the financial statements.

Once the scope is defined, our recommendation is to require the auditor to apply the scope to management’s assessment of which laws and regulations for which noncompliance would be “probable” of having a material effect on the financial statements in the event of noncompliance. We note that management’s inventory of potential laws and regulations is currently limited to the laws and regulations that the company is subject to pursuant to securities laws under Regulations S-K and S-X as well as the SEC’s definition of what is included in a company’s internal control over financial reporting.

Subject to this analysis being appropriately defined as described above, it would be reasonable for the auditor performing the analysis, as described in proposed AS 2405.06a.2 and proposed AS 2110.26, to understand management’s processes for identifying laws and regulations, perform inquiries, read board minutes, review legal invoices, obtain legal letters from internal and external counsel, read correspondence with regulators and other experts engaged by the company, and obtain representations from management.

This substantial refinement in scope that we recommend, along with our recommendation discussed above, would strengthen the procedures being performed over NOCLAR by auditors and would help support an auditing standard that is practical and operable.

However, it is worth noting that even if with the clarification of the scope of the potential laws and regulations that the auditor is required to evaluate as described above, such an evaluation would still require a significant increase in the use of specialists. These types of procedures would be consistent with those that auditors currently execute on a company’s tax returns, since the company’s compliance with federal, foreign, state and local tax rules and regulations is considered direct law and regulation. For example, auditors currently utilize and rely heavily on federal, foreign and state and local tax specialists in the performance of auditing procedures that would include inquiring of management whether the company is subject to any Internal Revenue Service, state or local audits, review correspondence between the company and the auditor, review the company’s analysis of any significant federal, state or local tax positions taken (including legal opinions and other analysis, as applicable), review the return to provision reconciliation to identify significant reconciling items as well as review board minutes, and obtain representations from management.

Section 404(b) – Proposed AS 2110.26

While we support requiring the auditor to understand management’s process as described in proposed AS 2110.26, as it relates to the company’s financial reporting process, we suggest that the PCAOB clarify whether the auditor also would be required to understand such process in accordance with Section 404(b) of the Sarbanes-Oxley Act (Section 404). AS 2201.01 states “[t]his standard establishes requirements and provides direction that applies when an auditor is engaged to perform and audit of management’s assessment of the effectiveness of internal control over financial reporting (‘the audit of internal control over financial reporting’) that is integrated with an audit of the financial statements.” Further AS 2201.09 states the “auditor should properly plan the audit of internal control over financial reporting and properly supervise the engagement team members. When planning an integrated audit,

the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures – ... [I]legal or regulatory matters of which the company is aware." Consistent with the SEC staff guidance referenced in the Auditor's independent assessment section above which states that the scope of a company's assessment of internal control over financial reporting only includes laws and regulations that are directly related to the preparation of the financial statements and because indirect laws "relate more to an entity's operating aspects than to its financial and accounting aspects"¹¹ it is not clear whether indirect laws would be included in the scope of ICFR as noted above. This is the case specifically with respect to AS 2201.09 since the current standard only addresses legal or regulatory matters of which the company is aware and not all indirect laws that the company may be subject to. Accordingly, consistent with our other recommendations, we would anticipate, and we urge, the PCAOB to clarify that these matters are excluded from the scope of the auditor's assessment of the company's compliance of internal control over financial reporting.

Reading publicly available information – Proposed AS 2110.11

While we are supportive of auditors reading publicly available information under extant AS 2110.11, including company-issued press releases, company-prepared presentation materials for analysts or investor groups, analyst reports, and transcripts of earnings calls and other meetings with investors or rating agencies, we are not supportive of requiring auditors to read all publicly available information. Compliance would be extremely challenging for most issuer audits and potentially not achievable for others, given the sheer volume of information that would have to be evaluated by an auditor (including evaluating whether the source was reliable) regardless of whether there is a system in place to efficiently monitor and collect such information.

Many companies have complicated organizational structures with large numbers of subsidiaries, all of which would require constant monitoring and review by the auditor for internally and externally generated publicly available information. Further, based on the broad definition of executive officers in extant AS 2110.A3A, auditors would potentially be required to frequently request, obtain and verify the completeness and accuracy of all social media accounts for a significant number of people. The auditor also would have to frequently monitor and review all such social media accounts. We believe the proposal fails to address the expected effort and cost of such complex and consuming monitoring compared with the potential benefit that may be obtained. Accordingly, we recommend that the proposal retain the extant AS 2110.11 wording in the final standard.

Inquire of others – Proposed AS 1210.57d

Proposed AS 1210.57d states auditors should inquire of "others within the organization likely to have knowledge regarding ... (3) the existence of instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations." We believe the proposal defines "others within the organization" very broadly and, as a result, it would require inquiries to be made from a large population of individuals in an organization.

¹¹ Extant AS 2405.06

For large, multinational organizations, the number of individuals involved could easily reach well into the thousands. That is, due to the large number of potential laws and regulations that companies would have to comply with, this proposed requirement appears to relate to every person who is subject to and monitors a company's operational, financial or administrative decisions, including all employees, agents or contractors. Additionally, given the lack of a precise definition, it is likely that the application of the requirement would vary significantly in practice.

Given the extensive inquiries that would be required under proposed AS 2110 and the lack of examples (e.g., regulatory compliance department, human resource department) of other departments or functional responsibilities in the organization that auditors should specifically make inquiries of, we recommend deleting the reference to "others within the organization" in proposed paragraph AS 2110.57d.

Determine whether it is likely that any such noncompliance occurred – Proposed AS 2405.07

We strongly disagree with the proposed requirement in AS 2405.07 related to the auditor's obligation to "determine whether it is likely that any such noncompliance occurred" primarily because (1) making such a determination would require auditors to reach legal conclusions for which they have no training or competence, (2) auditors would be required to perform a role that blurs the lines between practicing accountancy and practicing law and assuming other management functions, and (3) the auditor would be required to rely heavily on others with specialized skills when making the determination.

Extant AS 2405.03 states "[w]hether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence 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."

Further, the *Code of Ethics for Professional Accountants* issued by the International Ethics Standards Board for Accountants (IESBA) addresses a number of topics, including responding to noncompliance with laws and regulations. Section 360.10A2 of the Code reinforces the auditor's limitations in extant AS 2405 when it states "[t]he professional accountant is expected to apply knowledge and expertise, and exercise professional judgment. However, the accountant is not expected to have a level of knowledge of laws and regulations greater than that which is required to undertake the engagement. Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body."

In line with this guidance and our experience with matters involving noncompliance with laws and regulations, auditors currently rely on others with specialized skills and knowledge outside of the auditor's core competencies in accounting and auditing to determine whether it is likely that noncompliance has occurred.

While the Board states in the proposing release 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," both extant and proposed AS 1210.01 state that the auditor uses "a specialist engaged by the auditor's firm ('auditor-engaged specialist') to assist the auditor in obtaining or evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure."

It is clear that the auditor would be responsible for drawing the final conclusion after evaluating the work of the auditor-engaged specialist under the proposal. Accordingly, we are concerned that auditors who are not trained nor qualified to make legal determinations would become responsible for legal determinations, and the proposal blurs the line for auditors between practicing accountancy and practicing law, in addition to them potentially assuming other management functions such as exercising compliance and monitoring roles.

We recommend that the final standard remove the requirement in proposed AS 2405.07 related to the auditor's obligation to "determine whether it is likely that any such noncompliance occurred." In practice, under the proposed standard auditors would be put into positions of having to draw such conclusions in advance (possibly well in advance) of the conclusion of the legal or regulatory process, given the periodic nature of financial reporting. As a result, auditors will be drawing conclusions under a different threshold as provided by the proposal than company management. US GAAP requires management to apply the guidance provided within ASC 450 for these purposes, which will likely lead to different conclusions being reached by the auditor and management. Confusion and lack of clarity over these apparent inconsistencies will erode transparency and as a result, investor confidence would be adversely impacted.

Determining the possible effect on the financial statements and other information – Proposed AS 2405.09b(2)

Proposed AS 2405.09b(2) would require auditors to evaluate whether likely noncompliance with laws or regulations "result[s] 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."

However, information in the financial statements on potential noncompliance with laws and regulations is based on the guidance in ASC 450, which requires a company to recognize an estimated loss from a loss contingency when the estimated loss is both probable and can be reasonably estimated. ASC 450 also requires a company to disclose a loss contingency that is probable but cannot be reasonably estimated. Accordingly, the proposed requirement to evaluate "likely noncompliance" would appear to require auditors to perform more evaluations than those that management is required to perform under ASC 450 to determine whether a loss is "probable." The proposed requirement may also result in more disclosures than those required under US GAAP because "likely" appears to be a lower threshold than "probable" as required under ASC 450, ultimately resulting in inconsistencies between a company's responsibilities for disclosure under US GAAP and the auditor's obligations under proposed AS 2405.

Further, "likely" appears to have a different definition than "reasonably likely" as defined by Item 303 of Regulation S-K. We recommend that the final standard require auditors to focus solely on whether company management has complied with the reporting and disclosure requirements under US GAAP and the disclosure requirements mandated by the SEC. We suggest including the FASB and the SEC in outreach, as discussed in our comments on the effective date below.

Clarifications to proposed AS 2405.11 (remedial action)

We believe proposed AS 2405.11 should be clarified to address whether “timely” and “as soon as practicable” have similar meanings.

We also believe more clarity is needed to address how auditors should evaluate “senior management.” Should they evaluate each member of senior management with whom they have communicated individually or in the aggregate? Further, how should auditors apply the definition of senior management in a group audit structure?

Consider a fact pattern where the auditor becomes aware of noncompliance at a subsidiary that is not a registrant, and the auditor believes that senior management of the subsidiary has not taken timely and appropriate remedial action. However, the auditor concludes that the parent, which is the registrant, has taken appropriate remedial action. Given the complex organizational and operational structures of many companies, we believe additional clarity with respect to who within a company meets the definition of senior management is necessary to make this paragraph of the proposal operational in practice.

Communicating noncompliance with laws and regulations – Proposed AS 2405.12-2405.15

We support increasing the communications between auditors, the appropriate level of management and the audit committee related to noncompliance with laws and regulations. However, proposed AS 2405.12 should be revised to provide more flexibility.

The proposing release notes that “Congress passed Sarbanes-Oxley, which induced provisions requiring (i) audit committees to establish procedures for the receipt of complaints about accounting, internal control, and auditing matters.” Extant AS 2405.17 operationalizes such audit committee procedures over auditing matters regarding the cadence of communications with the audit committee when it states “[t]he auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated.”

The proposed requirements to communicate to the audit committee any noncompliance that “may have occurred,” “unless clearly inconsequential” and to do so “as soon as practicable and before the issuance of the engagement report” would be highly likely to result in a dramatic increase in the number of items requiring communication to the audit committee, certainly with respect to companies in highly regulated industries (e.g., banking and energy) and companies that have international operations. However, discussing all of the potential issues that may arise before the facts and materiality are known to both management and the auditor would not be a productive use of time for auditors, management or audit committees. Requiring this level of communication may ultimately be detrimental to audit quality because the auditor’s and the audit committee’s focus would be diverted from actual or potentially more material or significant matters.

We recommend that the Board consider a tiered communication approach whereby the auditor and the company would agree on the frequency and level of communication (consistent with extant AS 2405), which could encompass the following:

- ▶ Auditors communicate with management regarding information indicating noncompliance has or may have occurred, unless clearly inconsequential (see below for our recommendation for how to determine that information is inconsequential)
- ▶ Auditors communicate with the audit committee, as soon as practicable and before the issuance of the engagement report, regarding information indicating noncompliance involving senior management has or may have occurred

We do not agree with the proposal to mandate further communications from the auditor to the audit committee regarding noncompliance. The audit committee is in the best position to determine the cadence and scope of additional communications with the auditor on potential items involving noncompliance with laws and regulations that do not involve senior management because audit committees already determine the level and type of information they get from the company on a variety of matters, including whistleblower programs/reports, reports from the general counsel on the status of litigation and potential noncompliance with laws and regulations, and other compliance programs. As a result, much of the mandated communication would be duplicative for the audit committee.

With respect to proposed AS 2405.14, for all items discussed with the audit committee based on our suggested modifications to proposed AS 2405.12 above, we believe that if such initial discussions occur before the auditor completes their evaluation, the auditor should subsequently communicate the results of their final evaluation to the audit committee as provided in proposed 2405.14, including whether the noncompliance was determined to be inconsequential based on a threshold established by the audit committee.

Communication protocols, including the establishment of an inconsequential amount, should be required and discussed with the audit committee annually and documented contemporaneously in the auditor's workpapers. Since extant AS 2405.17 provides for effective and operational auditor communications with the audit committee, we believe the extant provisions are fit for purpose and do not require significant modification. Further, we believe that the proposed "appropriate level of management" is not clearly defined and it is unclear how this term differs from "senior management" as used in proposed AS 2405.11.

While the language in proposed AS 2405.13 is clear, we believe that .13b should be modified to remove the auditor's obligation to "determine that the matter is likely noncompliance" because this would result in the auditor performing a management function. We recommend that the auditor's communication be limited to their assessment of management's conclusion with respect to likely noncompliance, including whether it is in accordance with the applicable accounting standards and whether the possible effect on the financial statements cannot be reasonably determined at such time. We suggest the following changes:

If the auditor has determined *whether management's conclusion* that the matter is likely noncompliance, the possible effect of the noncompliance on the financial statements, **or that the possible effect on the financial statements cannot be reasonably determined at such time**, and

other information in documents containing the audited financial statements *is recorded and disclosed in accordance with the applicable accounting standards.*

Further, our view is that the auditor's communications in proposed AS 2405.13b involving the "possible effect of the noncompliance on ... other information in documents containing the audited financial statements" should not be expanded beyond what is currently required in extant AS 2710.04 and .05. That is, the auditor should only be required to communicate in instances where the auditor has identified material inconsistencies between the information included in the financial statements and the other information in documents containing the audited financial statements, not in every instance.

Amending AS 4105, *Reviews of Interim Financial Information* – Proposed AS 4105.23

The proposal's requirements related to interim reviews and the auditor's obligations regarding noncompliance with laws and regulations is unclear. The note to proposed AS 4105.23 states that "[i]f in performing a review of interim financial information, the accountant identifies or otherwise becomes aware of information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred, the accountant must determine its responsibilities under AS 2405, *A Company's Noncompliance with Laws and Regulations*, and Section 10A of the Securities Exchange Act of 1934." We are concerned that this note and footnote 15A may be interpreted to require the auditor to use any information obtained as part of performing the interim review to comply with AS 2405 and Section 10A in the context of the annual financial statement audit, including complying with the related timelines. However, when compared with the requirement in proposed AS 4105.32 which states, "[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 could be interpreted to require the auditor to perform a full evaluation of whether any noncompliance with laws or regulations, including fraud, has or may have occurred prior to the company filing its Form 10-Q.

Given the potential number of matters that could arise that would initially be deemed to be more than insignificant and therefore require an audit response, as well as the level of effort and involvement from management, management's specialists, the auditor and the auditor's specialist, it would be extremely unlikely that the company and the auditor would be able to complete their respective procedures for the purposes of drawing a conclusion on every matter in the compressed Form 10-Q reporting timelines required by the SEC. Further, as discussed in the Determine whether it is likely that any such noncompliance occurred section above, we are concerned that auditors would be required under proposed AS 2405 to form a conclusion or come to a different conclusion before companies conclude in accordance with ASC 450 due to the apparent different thresholds.

We also do not believe that such a complete evaluation is warranted on an interim basis. A requirement of this nature could likely increase dramatically the number and frequency of companies unable to timely file their financial statements. This would ultimately negatively impact investors who will face delays in receiving important company disclosures. The delay may also impede a company's ability to access the capital market and impact its market capitalization, among other possible effects. Accordingly, we believe the note to proposed AS 4105.23 should be removed in the final standard.

Definition – Proposed AS 2405.A2

The proposed definition of noncompliance with laws and regulations in proposed AS 2405.A2 would exclude those charged with governance from the list of individuals acting on behalf of or in a company's capacity. Given the important role that those charged with governance play, we recommend including them in the definition by revising the definition as follows:

Noncompliance with laws and regulations – An act or omission, intentional or unintentional, by the company whose financial statements are under audit, or by the company's management, ***those charged with governance, the company's*** ~~its~~ employees, or others that act in a company capacity or on the company's behalf, that violates any law, or any rule or regulation having the force of law. Noncompliance with laws and regulations includes fraud as described in paragraph .05 of AS 2401, *Consideration of Fraud in a Financial Statement Audit*. Noncompliance with laws and regulations does not include personal conduct by the company's personnel unrelated to the business activities of the company.

Other Questions Related to the Proposal

Economic impacts

While the proposing release observes the proposed new requirements would impose potentially substantial costs, we believe that the proposal's full economic impact on both companies and auditors would be significantly more onerous than the proposal recognizes, based on the significant time and effort that would be required to comply with it, as well as the additional specialists that would be required. In addition to the costs discussed below in our comments on the effective date, significant costs would be incurred by auditors to develop methodologies, train audit staff and internal specialists, enter into agreements and develop working protocols with external specialists (to the extent internal specialist resources are not adequate), and modify firm operational structures to coordinate and oversee the various specialists and their integration into each audit.

These increased costs would be borne by companies and their investors, and we encourage the PCAOB to widely consult with these stakeholders to both quantify the costs of adopting the proposal as written and clarify why the benefits exceed those costs.

Unintended consequences

Widening of the expectation gap

We agree that the proposal would likely result in the unintended consequences identified in the proposing release. Further, in our view, the proposal would have the additional unintended consequence of widening the expectation gap between the level of assurance the auditor's opinion provides (reasonable assurance) and the level of assurance that investors and other users of the audited financial statement may perceive that auditors have a responsibility to provide (absolute assurance). Compliance with laws and regulations, including maintaining effective processes over such compliance, remain the responsibility of company management. The proposed standard would suggest that the auditor has primary responsibility for aspects of this compliance, rather than

management. This would likely have the unintended consequence of users of companies' financial statements not understanding who bears the primary responsibility for evaluating compliance with laws and regulations.

We also believe that, given the significant expansion in an auditor's responsibilities and the likely significant increase in legal exposure from complying with the proposal as a result of auditors being required to reach legal conclusions, the auditing profession could face profession retention challenges.

Legal privilege

We believe the proposal would raise significant concerns among issuers regarding the expanded waiver of their legal protections. Under extant AS 2405 and Section 10A, auditors are required to obtain sufficient information to satisfy their obligations when they become aware of instances of noncompliance. Currently, this requirement is in tension with the interests of a company's internal and external counsels in protecting the company's attorney-client privilege or other legal protections. We believe the proposal would significantly increase the amount of protected information auditors would ask for and the frequency of those requests.

The proposing release does not adequately address the potential impact of this expansion of waiver of clients' legal protections. It also doesn't address the impact of a company's failure to provide the requested evidence, which could result in an auditor being unable to obtain sufficient appropriate audit evidence.

Address NOCLAR and fraud projects together

We note that the Board's mid-term standard-setting agenda currently includes a related project on fraud, and we recommend the Board address both projects at the same time. A targeted, single project is more likely to produce two consistent audit standards that can be more readily understood and operationalized by auditors.

Lastly, we share Mr. DesParte's concern expressed in the following statement: "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."¹²

Effective date

The potential implications of the proposal would likely be far reaching and may impact stakeholders that may not formally provide comments due to the relatively brief comment period. We highly encourage the Board and staff to perform additional outreach to all applicable stakeholders, including investors, audit committees, auditors, company management, the FASB, US and international regulators (including the SEC), and rating agencies.

¹² 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 M. DesParte on 6 June 2023.

Based on the comprehensive stakeholder feedback we expect the PCAOB would receive through such additional outreach, we further suggest that the PCAOB convene a task force of representatives of companies and their audit committees from a wide range of industries (including highly regulated industries), companies of different sizes, and companies with and without international operations to further understand the operational and economic impact on companies, their audit committees and their auditors. We believe the input from these efforts would help improve the proposal and benefit investors. We suggest that the PCAOB consider reissuing the proposal to reflect such additional input as well as comments received through this current consultation due to the significance of concerns. We believe this supports the PCAOB in accomplishing its objectives to strengthen and enhance the auditor's obligations regarding a company's noncompliance with laws and regulations.

If the standard is finalized as proposed, we believe that auditors would not be able to comply with it for fiscal years beginning after the year of SEC approval. To comply with the proposal, auditors would need to consider exponentially increasing their staffing of specialists, including lawyers and other consultants with expertise in areas such as the Foreign Corrupt Practices Act (FCPA), environmental protection, labor law, occupational safety and health, cybersecurity, banking and other financial products and services, securities markets and trading, antitrust, anti-money laundering, terrorist financing and proceeds of crime, price-fixing, privacy, Food and Drug Administration, data protection, tax and pension liabilities and payments, and consumer protection for all countries in which their audit clients operate. Auditors would also need to design and implement an audit methodology and update their systems of quality controls to comply with and appropriately operationalize the proposal.

In addition, companies would require significant time to document and formalize their legal compliance process, prepare and maintain audit evidence (including developing or improving IT systems) and potentially increase both staffing and the use of external attorneys and other specialists to answer auditor's questions.

Accordingly, we believe the period of time required to comply with the proposal should be significantly expanded to a minimum of two years after the year of SEC approval.

* * * * *

We want to again thank the Board and its staff for its consideration of this letter. We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,





Copy to:

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

Gary Gensler, Chair
Hester M. Peirce, Commissioner
Caroline A. Crenshaw, Commissioner
Mark T. Uyeda, Commissioner
Jaime Lizárraga, Commissioner
Paul Munter, Chief Accountant
Diana Stoltzfus, Deputy Chief Accountant

Appendix

Examples of the level of effort that an auditor would be required to comply with the proposal's indirect law or regulation risk assessment approach

Description of the indirect law or regulation that is subject to the auditor's risk assessment approach	<p>Example 1: Aggressive sales practices</p> <p>The auditor assesses whether there are, or could be, any operational policies in place that would incentivize salespeople to engage in aggressive sales practices, since this practice may violate consumer protection laws.</p>	<p>Example 2: Discrimination in residential mortgage lending</p> <p>The auditor assesses whether the lending policies of a financial institution align with various laws, including the Fair Housing Act (FHA), the Equal Credit Opportunity Act (ECOA) and the Community Reinvestment Act (CRA)¹³ as well as whether those policies are being followed.</p>	<p>Example 3: Violation of an environmental law and regulation</p> <p>The auditor assesses whether there is, or could be, noncompliance with the Clean Air Act since noncompliance could have a material effect on the company's the financial statements.</p>
Obtain an understanding	<p>The auditor would start their risk assessment procedures by obtaining an understanding of the company's sales strategy through:</p> <ul style="list-style-type: none"> ▶ Identifying a specialist with expertise in consumer protection laws to assist the audit team in understanding the specific requirements to assist in the risk assessment process. ▶ Reading all documented sales practices prepared by the company related to delivery mechanisms most likely to be used (e.g., written policies, policies communicated to staff by email, messaging/communication over instant messaging software and devices), including existing, new or changes to existing sales policies and practices. 	<p>The auditor would start their risk assessment procedures by obtaining an understanding of the financial institution's lending policies through:</p> <ul style="list-style-type: none"> ▶ Identifying a specialist with expertise in FHA, ECOA and CRA laws to assist the audit team in understanding the specific requirements to assist in the risk assessment process. ▶ Reading all documented lending policies prepared by the company (e.g., written policies, policies communicated to staff by email, messaging/communication over instant messaging software and devices), including existing, new or changes to existing lending policies and practices. 	<p>The auditor would start their risk assessment procedures by obtaining an understanding of the company's operational policies and procedures involving the Clean Air Act through¹⁴:</p> <ul style="list-style-type: none"> ▶ Identifying a specialist with expertise in the Clean Air Act to assist the audit team in understanding the specific requirements to assist in the risk assessment process. (Similar assessments would be required for every state, municipality and jurisdiction both in the United States as well as for every foreign country and jurisdiction in which the company operates to address other similar laws and regulations, beyond the Clean Air Act.)

¹³ Other relevant federal laws and regulations include: Truth in Lending Act, Ability-to-Repay/Qualified Mortgage Rule, Real Estate Settlement Procedures Act, TILA-RESPA Integrated Disclosure Rule, Home Ownership and Equity Protection Act Rule, Homeowners Protection Act, Secure and Fair Enforcement for Mortgage Licensing Act.

¹⁴ Other relevant federal environmental laws and regulations include: Clean Water Act, Oil Pollution Act, Endangered Species Act, National Environmental Policy Act, Toxic Substances Control Act, Noise Control Act, National Historic Preservation Act, Atomic Energy Act, Ocean Dumping Act, Comprehensive Environmental Response, Compensation and Liability Act, Emergency Planning & Community Right-to-Know Act, Federal Insecticide, Fungicide & Rodenticide Act, Occupational Safety & Health Act, Pollution Prevention Act, Resource Conservation and Recovery Act, Safe Drinking Water Act, Superfund Amendments and Reauthorization Act, Coastal Zone Management Act, Nuclear Waste Policy Act, Fish and Wildlife Coordination Act, Wilderness Act, and National Forest Management Act.

	<ul style="list-style-type: none"> ▶ Making inquiries of employees with varying levels of authority in the company, including salespeople, sales supervisors, regional/divisional managers, human resources professionals, internal audit, employees in departments that handle and oversee customer returns and complaints, in-house and potential external counsel that handles contracts and litigation, and executive management. ▶ Reading advertisements, marketing promotions and other communications with potential customers to determine whether materials contained any inappropriate sales practices. ▶ Reading internal audit reports, if applicable and determining whether there are possible indicators of noncompliance with all relevant operational policies. ▶ Reviewing whistleblower logs to evaluate the potential for noncompliance. ▶ Reading publicly available information (please refer to Reading publicly available information section above). 	<ul style="list-style-type: none"> ▶ Determining the financial institution's "lending area(s)" based on which markets the institution operates in; collect current information about the demographics in the financial institution's lending areas, at a sufficient level of granularity (e.g., census tract-level information). ▶ Evaluating whether the financial institution includes its lending areas in its assessment area for its compliance with the CRA, which would include comparing the demographics of its lending areas with its CRA assessment areas. ▶ Making inquiries of employees with varying levels of authority in the company, including lending representatives/originators, lending officers and supervisors, credit committee members, internal audit, in-house and potential external counsel that handles originations and litigation and executive management. ▶ Determining whether there are possible indicators of noncompliance with the FHA, ECOA or CRA laws based on company documented compliance with the acts. ▶ Evaluating whether staffing of lending personnel is adequate across the markets in which the financial institution operates, which might include reviewing workload distribution, how the financial institution re-assigned responsibilities in response to staffing turnover and the demographic makeup of a particular branch's lending personnel vis-à-vis the local market. 	<ul style="list-style-type: none"> ▶ Reading all documented policies involving The Clean Air Act prepared by the company related to delivery mechanisms most likely to be used (e.g., written policies, policies communicated to staff by email, messaging/communication over instant messaging software and devices), including existing, new or changes to existing policies and practices. Those policies would have to be reconciled to the Clean Air Act to ensure they comply with the requirements of the Act. ▶ Determining whether there are possible indicators of noncompliance with the Clean Air Act based on company documented compliance with the required regulations. ▶ Making inquiries of employees and experts engaged by the company with varying levels of authority, including people responsible for monitoring and evaluating compliance with the Clean Air Act at both stationary and mobile sources, internal audit, in-house and potential external counsel that handles environmental compliance and litigation, and executive management. ▶ Reviewing whistleblower logs to evaluate the potential for noncompliance. ▶ Reading internal audit reports, if applicable. ▶ Reading publicly available information (please refer to the Reading publicly available information section above). ▶ Monitor the status of any changes in the Clean Air Act to update the auditor's risk assessment throughout the audit.
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		<ul style="list-style-type: none"> ▶ Determining whether there are possible indicators that the financial institution could be viewed as insufficiently providing credit to certain demographic groups, which would include reviewing information about loan applications and originated loans, comparing across different markets in which the financial institution operates and evaluating the statistical significance of differences between the institutions and peers (separately, determine what constitutes the institution's "peer" group). ▶ Review the financial institution's advertising spending across markets and assess whether it may be inequitable or insufficiently targeted toward demographic groups that exhibit low loan demand. ▶ Reading internal audit reports, if applicable. ▶ Reviewing whistleblower logs to evaluate the potential for noncompliance. ▶ Reading publicly available information (please refer to the Reading publicly available information section above). 	
<p>Determine whether the identified indirect law or regulation "could reasonably have" a material effect on the financial statements</p>	<p>At a minimum, the auditor would evaluate how geographically widespread the practice is, how significant the practice could be to an individual sale, how long the practice has been in effect, whether the practice applies to all of the company's products, and whether and what the different consumer protection laws are in each jurisdiction where the practice exists. Once the auditor has accumulated all of this information, the auditor then measures the potential materiality (most likely by using specialists), taking into consideration of the factors identified above and concluded</p>	<p>At a minimum, the auditor would evaluate how geographically widespread the practice is, how significant the practice could be, how long the practice has been in effect, and whether and what the different lending laws are in each jurisdiction where the practice exists. Once the auditor has accumulated all of this information, the auditor then measures the potential materiality (most likely by using specialists), taking into consideration the factors identified above and concluded upon.¹⁵ This assessment would be performed by members of the audit team and their internal or external specialists, including</p>	<p>At a minimum, the auditor would evaluate how geographically widespread compliance with the Clean Air Act is, how significant noncompliance could be, how long the Clean Air Act has been in effect and whether there were any changes made during the period under audit. Once the auditor has accumulated all of this information, the auditor then measures the potential materiality, taking into account consideration of the factors identified above and concluded upon.¹⁵ This assessment would be performed by members of the audit team relying heavily on their specialists with expertise in the Clean Air Act, and include</p>

	<p>upon.¹⁵ This assessment would be performed by members of the audit team and their internal or external specialists, including those with expertise in consumer protection law in each of the jurisdictions where the company operates, and include the evaluation of information regarding both historical and current legal judgments and fines for similar violations across the different jurisdictions.</p>	<p>those with expertise in lending laws in each of the jurisdictions where the company operates, and include the evaluation of information regarding both historical and current legal judgments and fines for similar violations across the different jurisdictions.</p>	<p>the evaluation of information regarding both historical and current legal judgments and fines for similar violations across the different jurisdictions.</p>
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Ultimately, the auditor's procedures would most likely generate a very wide range of potential results all at a very low level of precision since all of these inputs are extremely judgmental and do not use market data. This same, or similar, risk assessment process would have to be performed for each law and regulation to which the company is subject to determine whether each "could reasonably have" a material effect on the financial statements.

Accordingly, we believe that the level of effort that the auditor would have to expend to identify the population of laws and regulations to evaluate further for noncompliance, while not aligning with the auditor's core competencies, is an all-encompassing exercise that would duplicate the company's efforts, dominate the auditor's time and efforts and dwarf the level of effort expended for all other facets of the audit.

The level of effort expended would not proportionately improve audit quality. Instead, it would have the opposite effect since it would divert focus and attention from other critical areas of the audit. We also recognize that regulators are already fulfilling duties within their clear mandates to address noncompliance matters (e.g., a federal banking regulator may identify indicators of potential noncompliance within a financial institution's data as part of periodic examinations that may cause the banking regulator to refer a potential matter to the US Department of Justice, which may investigate further and issue a civil action complaint).

These examples do not illustrate the level of effort and procedures the auditor would have to perform under proposed AS 2405.05(b) and (c) if the auditor determines that noncompliance could reasonably have a material effect on the financial statements. We believe the level of effort expended by the auditor to perform procedures to determine whether noncompliance is likely would be similarly robust with regards to level of effort by the auditor and its specialist(s).

Please refer to our comments in the economic impacts section of our comment letter addressing the expected costs to companies in connection with the significant increase in audit efforts that would be required under the proposal.

¹⁵ We would expect that a different model would most likely be developed for each law or regulation risk assessed because the assumptions and analysis would differ materially.