



August 2, 2023

Ms. Phoebe W. Brown  
Secretary  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, DC 20006-2803

**Re: Proposing Release: *Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations* (PCAOB Release No. 2023-003, June 6, 2023; PCAOB Rulemaking Docket Matter No. 051)**

Dear Ms. Brown:

The U.S. Chamber of Commerce (“Chamber”) Center for Capital Markets Competitiveness appreciates the opportunity to comment on the Public Company Accounting Oversight Board (“PCAOB” or “Board”) Exposure Draft on *Company's Noncompliance with Laws and Regulations* (“Exposure Draft” or “Proposal”), which is part of the Board’s standard-setting agenda to update and modernize PCAOB Auditing Standards (“AS”). While the Chamber supports the PCAOB’s goal to update its auditing standards with thoughtful consideration and due process<sup>1</sup>, however, we do not believe that the Proposal meets that goal.

The PCAOB has failed to explain its reasoning for the proposal and has not provided commenters with a sufficient cost benefit analysis. As we explain in greater detail below, the Proposal, if enacted, could degrade audit quality, harm investor protection, weaken attorney client privilege protections, and impose additional audit costs on issuers by an estimated \$36 billion dollars, far exceeding Sarbanes-Oxley 404b implementation.

Accordingly, the Chamber respectfully requests that the PCAOB withdraw the Proposal.

Unfortunately, the Proposal represents neither a modernization nor an update of the extant PCAOB auditing standard – AS 2405 on *Illegal Acts by Clients*. Instead, the Proposal sweeps aside the existing standard and completely transforms the nature and scope of auditor responsibilities. Simply put, the Proposal turns the financial statement audit into a search to ferret out non-compliance with laws and regulations (“NOCLAR”) – without due consideration that such an assignment is the purview of lawyers. Auditors, who provide assurance for

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<sup>1</sup> For example, see the letters to the PCAOB from the U.S. Chamber of Commerce Center for Capital Markets Competitiveness on the PCAOB Concept Release on *Potential Approach to Revisions to PCAOB Quality Control Standards* dated March 16, 2020; the PCAOB Request for Comment on *Advisory Groups – Draft Governance Frameworks* dated February 28, 2022; and the PCAOB Request for Comment on the *Draft 2022-2026 Strategic Plan* dated August 16, 2022.

financial statements, are critical for investors to receive credible decision useful information, are not lawyers - auditors are proficient in accounting and auditing matters.

Yet, the Proposal expressly provides that NOCLAR has a broad meaning.<sup>2</sup> NOCLAR includes violations of any law or regulation affecting the company that arises from acts or omissions by the company, management, board members, employees, independent contractors, related parties, or others that act in a company capacity or on the company's behalf,<sup>3</sup> including personal conduct related to the business.<sup>4</sup> In this regard, the auditor would need to consider all laws and regulations (globally) – irrespective of whether the laws and regulations involve financial or operational issues or unintentional versus intentional conduct – for which the company may be held responsible, including in any disciplinary or administrative proceeding, or any civil or criminal action.<sup>5</sup> Furthermore, the Proposal would potentially require information to be provided to auditors in such a way to violate attorney-client privilege protections thus opening the company to additional wide-ranging litigation and discovery risks.

The Proposal outlines a series of complex duties that are not encompassed within the audit and therefore is beyond the remit of the PCAOB. Additionally, the Proposal fails to account for how an auditor should deal with a conflict of laws situation. For instance, the rule implementing the resource extraction provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act were struck down as they would require a business to disclose information that would be illegal under a third jurisdiction.

Such a sweeping and far-reaching transformation of the auditor's responsibilities, without any legislative mandate, necessitates compelling evidence of a significant, pervasive market failure. The Proposal provides no such evidence. Instead, the Board's justification for the Proposal appears to be based on a general statement that auditors have a fundamental obligation to protect investors and NOCLAR can result in legal and regulatory penalties as well as reputational loss.<sup>6</sup>

As to costs, the Exposure Draft states: "The Board recognizes that imposing new requirements would result in additional, potentially substantial costs for auditors and the companies they audit."<sup>7</sup> However, the Exposure Draft does not illuminate the nature of "substantial" and the economic analysis is otherwise weak. No attempt is made to quantify the expected costs of the Proposal or even provide baseline data – such as the current level of audit

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<sup>2</sup> The Exposure Draft mentions a few examples encompassed by the definition of NOCLAR such as violations of laws and regulations related to employment, occupational safety and health, consumer protection, antitrust, (federal, state, and international) privacy, and environmental protection (pages 4, 22, 24, and 32).

<sup>3</sup> The Proposal requires the auditor to assess noncompliance by agents of the company, which means auditors would need to understand the laws that determine when one party is acting as an agent of another party.

<sup>4</sup> See the Exposure Draft, pages 24 and 56.

<sup>5</sup> See the Exposure Draft, page 24.

<sup>6</sup> See the Exposure Draft, pages, 4, 5, and 69.

<sup>7</sup> For example, see the Exposure Draft, page 76.

fees for issuers and broker-dealers to facilitate assessing just one of the many aspects of the costs needing to be considered by the PCAOB.

Nonetheless, the costs of the Proposal will far exceed the costs of implementing Section 404 of The Sarbanes-Oxley Act of 2002 (“SOX”). As a touchstone, audit fees for public companies more than doubled between 2002 and 2004 during the implementation of SOX Section 404.<sup>8</sup> As discussed below, if the proposed requirements were to triple fees from their current levels, we conservatively estimate the increase in fees for public companies would exceed \$36 billion annually – without considering fee increases for audits of broker-dealers and others or any of the many additional one-time and on-going costs that would be imposed by the Proposal.

Further, the Proposal contravenes important concepts that underpin the U.S. financial reporting framework – raising attendant issues of PCAOB authority and regulatory policy. Moreover, the Proposal is not reasonable, operational, or workable. Even on paper, the Proposal collapses under its own weight. Consistent with these deep-seated problems, two Board members voted against the Proposal, in an historic first.

As a threshold matter, the Proposal is not fit for purpose. The Chamber strongly urges the Board to withdraw the Proposal and reconsider its approach to any modernization or updating of AS 2405 on *Illegal Acts by Clients*. As it stands, the Proposal risks going down in the annals of audit regulation as the quintessential example of audit standard-setting gone awry.

We next summarize the PCAOB’s extant standard, AS 2405 on *Illegal Acts by Clients*, the International Auditing and Assurance Standards Board (“IAASB”) standard on *Consideration of Laws and Regulations in an Audit of Financial Statements* (“ISA 250”),<sup>9</sup> and the PCAOB’s proposed standard. These summaries provide background and context for our subsequent discussion of concerns with the Proposal – both overarching concerns and those specific to the economic analysis of costs and consequences of it. We also provide recommendations for a path forward.

## **Background**

### *PCAOB AS 2405 on Illegal Acts by Clients*

The PCAOB’s extant standard on *Illegal Acts by Clients* recognizes that illegal acts vary considerably in their relation to the financial statements. The further removed an illegal act is

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<sup>8</sup> See *Twenty-Year Review of Audit & Non-Audit Fee Trends* by Audit Analytics (October 2022), page 6.

<sup>9</sup> The IAASB revised ISA 250 in 2016. The American Institute of Certified Public Accountants (“AICPA”) Auditing Standards Board (“ASB”) standard on *Consideration of Laws and Regulations in an Audit of Financial Statements* (AU-C 250) is substantially converged with ISA 250.

from the events and transactions ordinarily reflected in the financial statements, the less likely the auditor is to become aware of the act or to recognize its possible illegality.<sup>10</sup>

Thus, the standard distinguishes between laws and regulations that have a direct and material effect on the determination of financial statement amounts (e.g., tax laws that affect tax accruals and tax expense) and those that have an indirect financial statement effect (e.g., laws related to securities trading, occupational safety and health, food and drug administration, environmental protection, employment equality, and price-fixing or anti-trust). For the latter, the indirect effects are normally the result of the need for an entity to disclose a contingent liability because of allegations or determinations of illegality.<sup>11</sup> Importantly, the laws and regulations with indirect effects generally relate more to an entity's operating aspects; do not typically affect the financial statements; and are not captured by the entity's information systems relevant to financial reporting – specifically internal control over financial reporting (“ICFR”).

Further, the standard recognizes that auditors are not lawyers or qualified to practice law.<sup>12</sup> Auditors are proficient in accounting and auditing matters. Thus, determinations 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 require judicial determination.<sup>13</sup>

Given these realities, AS 2405 provides that 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 to indirect illegal acts, the auditor should be aware of the possibility that they may have occurred. If specific information comes to the auditor's attention that provides evidence of the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertain whether an illegal act has occurred.<sup>14</sup>

Otherwise, AS 2405 provides guidance on audit procedures in the absence of evidence concerning possible illegal acts, specific information concerning possible illegal acts, audit procedures in response to possible illegal acts, and the auditor's response to detected illegal acts. The latter includes guidance on the consideration of the financial statement effect, the implications for the audit, communications with the audit committee, the effect on the audit report, along with other considerations.<sup>15</sup> Other considerations recognize circumstances may

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<sup>10</sup> See AS 2405.04.

<sup>11</sup> See AS 2405.05 and AS 2405.06.

<sup>12</sup> PCAOB AS 2505.06 on *Inquiry of a Client's Lawyer Concerning, Litigation, Claims, and Assessments* likewise states: “An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention.”

<sup>13</sup> See AS 2405.03.

<sup>14</sup> See AS 2405.05 and AS 2404.07.

<sup>15</sup> See AS 2405.07 through AS 2405.24.

exist that give rise to a duty for the auditor to notify parties outside the entity, including pursuant to Section 301 of the Private Securities Litigation Reform Act of 1995 codified in Section 10A(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”) to make a report to the Securities and Exchange Commission (“SEC”).<sup>16</sup>

*IAASB ISA 250 on Consideration of Laws and Regulations in an Audit of Financial Statements*

ISA 250 distinguishes between laws and regulations that have a direct effect on the determination of material amounts and disclosures in the financial statements (such as tax and pension laws and regulations) and those that do not. However, ISA 250 appreciates that compliance with the latter may be fundamental to the operating aspects of the business, the ability to continue its business, or to avoid material penalties. In this regard, non-compliance with such laws and regulations may have a material effect on the financial statements (at some point).<sup>17</sup>

For those laws and regulations that have a direct effect on the financial statements, the auditor’s responsibility is to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations. For the other (formerly indirect) category, the auditor’s responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements (including inquiries of management and boards of directors and reviewing correspondence with regulators).<sup>18</sup> In addition, ISA 250 provides guidance on planning and performing procedures related to noncompliance, communicating noncompliance, and multi-location engagement considerations.<sup>19</sup>

*PCAOB Proposed Requirements*

The PCAOB Proposal completely abandons the direct versus indirect (other) distinction for illegal acts (NOCLAR). Instead, it establishes an unconditional obligation for the auditor to plan and perform procedures to identify all laws and regulations with which noncompliance “could reasonably” (a new and undefined term) have a material effect on the financial statements; to assess and respond to the risks of material misstatement based on the laws and

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<sup>16</sup> It is noteworthy that Section 10(A) uses the direct/indirect distinction for illegal acts and requires auditors to perform 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. Thus, the Proposal does not align with current SEC requirements.

<sup>17</sup> See the PCAOB’s *Comparison of New Proposed Standard AS 2405 with ISA 250 and AU-C Section 250* (June 6, 2023), page 5.

<sup>18</sup> *Ibid.*, pages 5 and 6.

<sup>19</sup> *Ibid.*, pages 7 through 21.

regulations identified; and to determine whether instances of noncompliance have or may have occurred.<sup>20</sup>

When the auditor identifies or otherwise becomes aware of information indicating noncompliance has or may have occurred (regardless of whether the effect of such noncompliance is perceived to be material to the financial statements), the auditor must evaluate such instances and communicate them, as soon as practicable, to senior management and the audit committee (unless the matter is clearly inconsequential).<sup>21</sup> The Proposal also prescribes a number of actions the auditor must take to evaluate noncompliance and determine if it has occurred.<sup>22</sup> If the auditor determines that it is likely that noncompliance has occurred, additional requirements come into play, including determining whether senior management has taken timely and appropriate remedial action with respect to noncompliance.<sup>23</sup>

To obtain an understanding about the nature and circumstances of any NOCLAR and determine whether it is likely that any such noncompliance has occurred, the Proposal recognizes that auditors might determine it is necessary to perform forensic auditing procedures and/or to augment engagement teams with specialized skills or knowledge outside of accounting and auditing.<sup>24</sup> Such specialized skills and knowledge include legal expertise as well as subject matter expertise across the array of global laws and regulations applicable to a company that evolve over time.

The Proposal also includes amendments for enhanced risk assessment procedures. For example, proposed requirements incorporate the Board's view that a company's strategy to grow, modify, or discontinue business operations is a potential business risk that might result in material misstatement of the financial statements or indicate potential noncompliance with laws and regulations, such as climate regulations.<sup>25</sup>

In addition, the Proposal includes specific requirements for auditors to obtain an understanding, among other matters, of management's processes related to:

- Identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements;
- Preventing, identifying, investigating, evaluating, communicating, and remediating instance of noncompliance; and

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<sup>20</sup> See the Exposure Draft, page A1-2.

<sup>21</sup> See the Exposure Draft, pages A1-2 and A1-7.

<sup>22</sup> See the Exposure Draft, pages A1-4 and A1-5.

<sup>23</sup> See the Exposure Draft, pages A1-6 through A1-9.

<sup>24</sup> See the Exposure Draft, pages A1-4 and A1-5.

<sup>25</sup> See the Exposure Draft, page A2-6.

- Receiving and responding to tips and complaints from internal and external parties regarding noncompliance.<sup>26</sup>

These proposed requirements encompass operating controls and transcend financial reporting. Thus, the Proposal extends auditor responsibilities on both integrated and financial statement-only audits well beyond ICFR.

This brief summary illustrates the transformative nature of the Proposal, which would apply to all audits conducted under PCAOB auditing standards – including those of issuers and broker-dealers – and whether the use of PCAOB auditing standards is mandated or voluntary. It is not possible to overstate the expansion of scope entailed in the proposed requirements to bring NOCLAR under the responsibility of auditors on financial statement audits.

Moreover, the Proposal provides limited guidance for auditors on how to accomplish these new requirements.<sup>27</sup> Overall, the Proposal focuses on articulating the auditor’s responsibilities and “holding the auditor’s feet to the fire” for complying with them – akin to establishing absolute assurance and a strict liability regime for the auditor’s NOCLAR responsibilities.

## Discussion

As previously noted, the Proposal contravenes important concepts that underpin the U.S. financial reporting framework – raising thorny issues of PCAOB authority and regulatory policy, along with other matters. This section discusses some of these issues.

### *PCAOB Authority*

The PCAOB lacks the statutory authority to extend auditor responsibilities on financial statement audits – from providing reasonable assurance that the financial statements (including footnote disclosures) comport with generally accepted accounting principles (e.g., “U.S. GAAP” as promulgated by the Financial Accounting Standards Board (“FASB”)) – to encompass determining compliance with all laws and regulations as proposed. This transformation of the financial statement audit was certainly not contemplated by SOX; is not a power the PCAOB has sought to assert in its two decades of existence;<sup>28</sup> and likewise exceeds the authority granted under Section 10A(a) of the Exchange Act. Moreover, it continues the

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<sup>26</sup> See the Exposure Draft, page 21.

<sup>27</sup> The Proposal does clarify that inquiries alone would be insufficient to determine compliance; although, inquiries may be sufficient to establish noncompliance.

<sup>28</sup> In determining where auditors should concentrate their efforts on evaluating internal controls for broker-dealers over compliance, the PCAOB (in collaboration with the SEC) determined the focus should be on financial responsibility rules, rather than all rules that apply to broker-dealers. The Proposal undermines this targeted approach that was developed after extensive consideration of risk, costs, and benefits.

Board's attempt to untether the financial statement audit from U.S. GAAP.<sup>29</sup> Relatedly, the Proposal requires auditors to become involved with a company's operational controls, which is outside the scope of SOX Section 404 and ICFR, and likewise raises serious questions of PCAOB authority. Furthermore, the Proposal raises significant issues under the Fourth Amendment to the Constitution, as essentially, the PCAOB is mandating the conduct of warrantless searches by auditors in a way that the Government could not do directly.

In addition to matters of authority, the Chamber questions the wisdom of the PCAOB expanding auditor responsibilities as proposed. Instituting such pervasive and onerous requirements related to NOCLAR will divert auditors' time, attention, and resources away from auditing the financial statements (and the effectiveness of ICFR on integrated audits) and otherwise distract auditors from their core responsibilities. Likewise, the proposed requirements have significant implications for companies. The Proposal will also divert management, employees, and audit committees away from financial reporting to focus on NOCLAR.

The Chamber is very concerned that the Proposal risks the high- quality financial reporting that is a foundation of U.S. capital markets. Further, it risks undermining the usefulness of public company financial statement audits and the trust and confidence that has been built-up in the independent audit function over the last several decades post-SOX. We believe this is not wise.

Importantly, aspects of the Proposal fail to align with essential elements of the U.S. financial reporting framework, which also touch on PCAOB authority and otherwise raise issues of regulatory policy. As discussed below, these elements include materiality, U.S. GAAP and SEC disclosure requirements, the auditor's obligation in financial statement audits, the regulatory and legal environment, and PCAOB Auditing Standards on training and proficiency and auditor independence.

### *Materiality*

Materiality is a bedrock of the U.S. capital markets.<sup>30</sup> The Supreme Court has held "that a fact is material if there is a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" (emphasis added).<sup>31</sup> The Supreme Court definition of materiality applies to the

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<sup>29</sup> For example, see the letter to the PCAOB from the U.S. Chamber of Commerce Center for Capital Markets Competitiveness on the PCAOB Proposed Auditing Standard – *General Responsibilities of the Auditor in Conducting an Audit* dated June 5, 2023.

<sup>30</sup> See, for example, U.S. Chamber Center for Capital Markets Competitiveness, *Essential Information: Modernizing Our Corporate Disclosure System* (Winter 2017).

<sup>31</sup> See *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 439 (1976) as cited in SEC *Staff Accounting Bulletin No. 99* (August 12, 1999).



securities laws and SEC rules and regulations, FASB standard-setting for U.S. GAAP, and PCAOB rules and standards.

Yet, the Proposal establishes an unconditional obligation for the auditor to identify all laws and regulations with which noncompliance could reasonably have a material effect on the financial statements. This is new terminology; it lacks clarity; and the Proposal fails to define it. The Chamber is at a loss to understand what it means. We agree with Board Member DesParte that “the filtering threshold of ‘reasonably could’ is not adequately explained in the proposal and is not addressed elsewhere in PCAOB standards.”<sup>32</sup>

The “could reasonably” threshold does not provide a practical filter for laws and regulations, as does the direct and indirect approach under extant auditing standards of the PCAOB (or the direct and other approach of IAASB and ASB). As it stands, as a pre-condition for applying a “could reasonably” requirement for noncompliance, the auditor would need to identify all laws and regulations applicable to a company. In addition, as noted by Board Member DesParte, among many other issues, it is unclear whether auditors would make this likelihood assessment on an inherent or a residual risk basis.

Further, as previously noted, the Proposal uses terms such as “may,” “might,” and “likely” in various contexts, which raise similar questions of meaning and intent. Along with not defining these terms, the Proposal makes no attempt to reconcile any of them with the Supreme Court definition of materiality – and its relevant concepts of “substantial likelihood” and “would.”

The Chamber is very concerned that the Proposal undermines the essential principle of materiality and attempts to force auditors to consider some broader concept instead.<sup>33</sup> In addition, the proposed terminology is ripe for second-guessing auditor judgments after the fact and facilitating PCAOB inspection deficiencies, PCAOB enforcement, SEC enforcement, and private securities litigation, along with attendant auditor reputation effects. None of these consequences serve audit quality or the interests of any stakeholder.

#### *U.S. GAAP and SEC Disclosure Requirements*

The Proposal lacks alignment with other aspects of the U.S. financial reporting framework, including U.S. GAAP. For example, at the date of the financial statements, NOCLAR typically involves loss contingencies with uncertainties as to existence, along with uncertainties

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<sup>32</sup> See *Statement on Proposal to Amend PCAOB Auditing Standards Related to a Company’s Noncompliance with Laws and Regulations and Other Related Amendments* by Duane M. DesParte (June 6, 2023).

<sup>33</sup> As Board Member DesParte states: “... wording suggests the auditor would be expected and held accountable to identify any and all information that might indicate instances of noncompliance of any law or regulation across the company’s entire operations, without regard to materiality.” See *Statement on Proposal to Amend PCAOB Auditing Standards Related to a Company’s Noncompliance with Laws and Regulations and Other Related Amendments* by Duane M. DesParte (June 6, 2023).

as to the amount and timing of any future cash outflows (e.g., for fines, penalties, and other settlements of legal actions, etc.) for those that do exist.<sup>34</sup>

U.S. GAAP for loss contingencies includes long-standing guidance for resolving the accounting and disclosure issues related to these uncertainties.<sup>35</sup> U.S. GAAP describes a likelihood continuum from probable, to reasonably possible, to remote. Loss contingencies are recognized in the financial statements if probable and the amount is subject to reasonable estimation. Reasonably possible loss contingencies (or those probable but not subject to reasonable estimation) are disclosed; and, with some exceptions, remote loss contingencies are neither recorded or disclosed.

Given the context in which it is used, terminology in the Proposal – such as “could reasonably,” “may,” “might,” or “likely” – does not appear aligned with U.S. GAAP in regards to the likelihood continuum for loss contingencies. In addition, the PCAOB’s proposed terminology is not aligned with SEC guidance for Management Discussion and Analysis (“MD&A”) disclosures under Item 303 for any known trends or demands, commitments, events, or uncertainties that will result in or are “reasonably likely” to result in the company’s liquidity increasing or decreasing in a material way. The Chamber recommends the PCAOB work with the SEC and FASB to ensure concepts and terminology in any revised NOCLAR proposal are aligned with SEC requirements and U.S. GAAP.

#### *The Auditor’s Obligation in Financial Statement Audits*

Throughout the Proposal, the PCAOB states that auditors have a fundamental obligation to protect investors. This claim is used by the Board as a justification for the proposed requirements on NOCLAR. However, this claim reflects the overall benefits from independent audits for investors in U.S. capital markets and the mission of the PCAOB in accordance with SOX Section 101(a).<sup>36</sup> It cannot be used by the PCAOB to justify auditing standards that create duties for auditors beyond the PCAOB’s authority. For example, in addition to matters previously discussed, the PCAOB cannot expect auditors to “get ahead of” or go beyond U.S. GAAP for loss contingencies with respect to NOCLAR. If the PCAOB has concerns about U.S. GAAP in regards to loss contingencies, these concerns should be communicated to FASB and the SEC.

#### *Regulatory and Legal Environment*

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<sup>34</sup> The identity of the party or parties to be paid may also be uncertain.

<sup>35</sup> See FASB Accounting Standards Codification (“ASC”) 450 on *Contingencies*.

<sup>36</sup> See the letter to the PCAOB from the U.S. Chamber of Commerce Center for Capital Markets Competitiveness on the PCAOB Proposed Auditing Standard – *General Responsibilities of the Auditor in Conducting an Audit* dated June 5, 2023.

The Proposal fails to appreciate the inherent legal complexities and uncertainties underlying compliance with laws and regulations that are particularly acute for some industries, such as financial services with its complicated and ever-expanding regulatory regime. These considerations raise a range of issues, including PCAOB authority for and the practicality and cost (for audit firms, companies, and broker-dealers) of the proposed assignment for auditors to ferret out NOCLAR – vis-à-vis the (overlapping) activities of many other federal, state, and non-U.S. regulatory agencies in conjunction with their authority.

In addition, the U.S is one of the most litigious countries in the world with an adversarial system and other unique features. For example, the plaintiffs' bar in the U.S. proactively looks for litigation opportunities involving companies, including signs that might be indicative of future share price declines. The U. S. also has more liberal discovery rules than any other country – plaintiffs are permitted broad scope for their inquiries. The Chamber is concerned that the proposed requirements for auditors, including as to details underlying GAAP and other disclosures, may go so far as to ultimately require companies to provide wide-ranging and legally privileged information to auditors. This will contribute to findings that companies have waived applicable privileges by disclosing to their auditor confidential and privileged communications with counsel regarding assessments of litigation and claims.

Relatedly, after the promulgation of U.S. GAAP on *Accounting for Contingencies*, the American Bar Association (“ABA”) approved a *Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information*.<sup>37</sup> Similarly, the AICPA Auditing Standards Executive Committee approved a Statement on Auditing Standards (now known as PCAOB AS 2505 on *Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments*) that was coordinated with the approach set forth in the ABA Statement. The agreed upon approach balanced the public interest in protecting the confidentiality of lawyer-client communications and the recognized dependence of the U.S. legal, political, and economic systems to an important extent on the public confidence in published financial statements.

The Chamber is very concerned that the Proposal will disrupt the approach agreed upon by the legal and auditing communities. The Chamber strongly urges the PCAOB to consider the broad and negative ramifications of the Proposal for auditors’ inquiries of client counsel and not undermine the long-standing approach that has served investors well.

#### *Auditing Standards on Training and Proficiency and Auditor Independence*

The Proposal appears to contravene, or at least undermine, important aspects of PCAOB Auditing Standards on general principles and responsibilities of the auditor, including those related to training and proficiency and auditor independence.

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<sup>37</sup> See *The Business Lawyer* (April 1976) pages 1709 to 1745.

For example, PCAOB Auditing Standards require auditors to be proficient in accounting and auditing. The independent auditor must undergo training adequate to meet the requirements of a professional. The attainment of the necessary proficiency begins with the auditor's formal education and extends to subsequent audit experience.<sup>38</sup>

As previously discussed, the PCAOB recognizes that the Proposal will require audit firms to routinely embed a variety of people in engagement teams with specialized skills, but without the necessary proficiency in accounting and auditing. This is very different than the current approach to illegal acts, which involves calling on specialized skills, such as legal expertise in limited circumstances and focused situations – more tangential to the conduct of financial statement audits. In addition, irrespective of whether audit firms directly employ the specialists or contract with third parties such as law firms, the specialists envisioned by the Proposal would need to understand and comply with all auditor independence and ethical requirements of the PCAOB and SEC.

The Chamber is very concerned that, while the Proposal establishes an expectation for the need to obtain specialized skills or knowledge outside of accounting and auditing, including legal expertise and subject matter expertise across the array of laws and regulations applicable to client companies, it does not reconcile this requirement with the PCAOB's extant standards or otherwise consider the consequences of it.

The Proposal also appears to directly contravene PCAOB and SEC auditor independence rules. The Chamber agrees with Board Member Ho that "... the proposal introduces ambiguities regarding auditor obligations to investors, by transforming the auditor's role of providing reasonable assurance to one of performing a management function."<sup>39</sup>

For example, the Proposal requires auditors to identify all laws and regulations that a company is subject to,<sup>40</sup> and assess other aspects of NOCLAR, including the efficacy of operating controls and company remediation efforts. Further, the proposed requirements would place auditors "in the shoes of management" (and the securities lawyers that advise management) to assess SEC 10-K and 10-Q filings in their entirety, as to whether different or additional NOCLAR-related information is necessary to make the filing not misleading, including information in MD&A and risk disclosures.

### **Economic Analysis**

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<sup>38</sup> See PCAOB AS 1010 on *Training and Proficiency of the Independent Auditor*.

<sup>39</sup> See *Statement on Proposed Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations* by Christina Ho (June 6, 2023).

<sup>40</sup> Board Member Ho notes that the securities laws and their implementing regulations for public companies do not even require management to identify all laws and regulations that the company is subject to. See *Statement on Proposed Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations* by Christina Ho (June 6, 2023).

As previously noted, the economic analysis of the Proposal is inadequate and does not provide the Board with a meaningful basis for assessing the costs and benefits of the Proposal. The economic analysis involves a high-level, very general, qualitative discussion of current audit methodologies, academic and other literature,<sup>41</sup> need,<sup>42</sup> and economic impacts. No quantitative data are provided or analyzed.

While the staff acknowledges that the costs of the Proposal will be substantial, the analysis fails to illuminate the meaning of substantial or recognize many of the costs and consequences of the Proposal. This section overviews just some of the costs and consequences, incremental to those previously discussed, that need to be addressed and provides some estimates of potential audit fees increases – just one type of cost of the Proposal that needs to be analyzed and considered by the Board.

It is not possible to overstate the magnitude of the one-time implementation costs and on-going performance costs that the Proposal will impose on audit firms globally. For example, one-time costs include those to develop methodologies, policies, and practices; educate and train partners and staff; revise quality controls; hire and train additional audit and forensic staff; hire legal and subject matter experts and/or contract with third-parties for such expertise and train such experts to function on engagement teams in an audit setting; globally field-test the methodologies, policies, and procedures before finalizing the implementation; and the list goes on.

Given the current challenges audit firms are facing in attracting and retaining talent, staffing challenges to implement the Proposal will be severe, especially for smaller audit firms.<sup>43</sup> Audit firms will also face market challenges to obtain the necessary specialized expertise of lawyers and others – particularly those that can meet the auditor independence requirements. It should be a very real concern that the existing labor markets for auditors and specialized expertise cannot support this Proposal. At a minimum, compensation and third-party contracting costs will significantly increase over existing baseline levels. In addition, smaller audit firms may not be able to overcome these challenges and will be forced to exit the

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<sup>41</sup> Anecdotes are inadequate for such a consequential proposal. The economic analysis provides no evidence to even hint at a “market failure” under AS 2405, such as, for example, a significant, systematic association between restatements and indirect illegal acts. The Board and staff do cite a study on *Occupational Fraud 2022: A Report to the Nations*, by the Association of Certified Fraud Examiners. Yet, this is a global study of 2,110 cases of occupational fraud that involves large multinationals, small private companies, government agencies, and nonprofits, among others. The audits of most of these entities are not under the purview of the PCAOB. In addition, the study reports that the typical fraud case causes a loss of \$8,300 per month and lasts twelve months before detection – which would be immaterial to the financial statements of most issuers and broker-dealers audited by PCAOB registered firms.

<sup>42</sup> As to need, the staff’s research suggests under AS 2405 that “auditors may not have sufficient incentives to identify, evaluate, and communicate a company’s noncompliance with laws and regulations” (page 69).

<sup>43</sup> Companies are likewise facing challenges in hiring and retaining accounting talent. For example, see the *Wall Street Journal* article on “Accountant Shortage Hits Corporations” by Mark Maurer (July 12, 2023).

market for PCAOB audits. The Chamber cannot support any PCAOB proposal that reduces competition among firms.

Moreover, the proposed requirements have significant implications for companies and will impose great costs on them, in addition to increases in audit fees. The Proposal does not sufficiently appreciate that the many audit requirements will likewise require company input and effort to enable the auditors to plan and perform the necessary procedures, assess and respond to risks, track down and address instances of noncompliance that have or may have occurred (which will include a number of false positives), and communicate these actions and findings.

As noted, the Proposal also embeds auditors in operating controls and the attendant consequences that unfolded from the implementation of SOX Section 404 will likely reoccur in the context of NOCLAR. As another concern, the proposed requirements are so comprehensive and onerous that the Proposal creates an unintended consequence of undermining the ability of companies and audit firms to meet deadlines for timely SEC filings.

These costs and consequences raise another fundamental issue that requires thoughtful economic analysis – namely the impact of the Proposal on initial public offerings (“IPO’s”). The Chamber is very concerned that the increased costs and consequences of the Proposal will create significant barriers to entry – reducing the attractiveness of companies participating in the U.S. public markets. Such a result would be to the detriment of all investors, but particularly smaller investors that do not have access to private investment opportunities.

Importantly, the Proposal is drafted as a standard that will impose strict liability on auditors for NOCLAR.<sup>44</sup> The Proposal will likewise facilitate PCAOB inspection deficiencies, regulatory enforcement by the PCAOB and SEC, and plaintiff lawsuits. The Proposal hands the plaintiff’s bar a second win from the PCAOB in less than three months.<sup>45</sup> The risks of these litigation and regulatory enforcement effects likewise need to be considered in analyzing the costs and consequences of the Proposal.

Although the PCAOB’s economic analysis of the Proposal fails to include any quantitative data or analysis, baseline data on audit fees for public companies are available from Audit

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<sup>44</sup> Relatedly, as Board Member DesParte states: “It is unclear whether the concept of reasonable assurance is applicable to the auditor’s identification of instances of noncompliance or information indicating noncompliance. Reasonable assurance, rather than absolute assurance, should apply ...” See *Statement on Proposal to Amend PCAOB Auditing Standards Related to a Company’s Noncompliance with Laws and Regulations and Other Related Amendments* by Duane M. DesParte (June 6, 2023).

<sup>45</sup> See the letter to the PCAOB from the U.S. Chamber of Commerce Center for Capital Markets Competitiveness on the PCAOB Proposed Auditing Standard – *General Responsibilities of the Auditor in Conducting an Audit* dated June 5, 2023.

Analytics.<sup>46</sup> We use the Audit Analytics data to estimate increases in audit fees under the proposed requirements, as one aspect of the costs of the Proposal.

Audit Analytics reports that audit fees for public registrants were \$15.5 billion in 2021, with another \$1.7 billion for audit-related fees. Assuming (conservatively) fee increases of three percent a year for 2022 and 2023 under extant PCAOB Auditing Standards, baseline estimates would be \$16.4 billion and \$1.8 billion for audit and audit-related fees, respectively, for a total of \$18.2 billion.

Fees more than doubled from 2002 to 2004 with the implementation of SOX Section 404. Applying this estimate to the Proposal would result in total fees of more than \$36.4 billion – an increase of \$18.2 billion over a baseline of \$18.2 billion. However, the costs of implementing SOX Section 404 will pale in comparison to the costs of the Proposal. In this regard, a conservative estimate for a tripling of fees would mean fees totaling more than \$54.6 billion – an increase of \$36.4 billion over a baseline of \$18.2 billion.

The \$36.4 billion increase in fees is a conservative estimate because it does not include fee increases for broker-dealers or other entities that are required to or voluntarily have financial statement audits in accordance with PCAOB Auditing Standards. Research also documents that audit fees doubled with the implementation of SOX Section 404 even for companies not subject to the new requirements. The researchers concluded that because there was no corresponding increase in the supply of experienced auditing personnel, the levels of audit fees were boosted “across the board.”<sup>47</sup> This problem will be exacerbated with the Proposal in the current environment.

Further, these estimates in audit fee increases do not consider other internal costs of the Proposal that would be imposed on companies. For example, one study found that audit fees accounted for one quarter of the total costs incurred by companies to implement and comply with SOX Section 404.<sup>48</sup>

In summary, the costs of the Proposal are not just substantial, but breath-taking. While they require more thorough analysis and consideration by the Board, based on preliminary evidence, prospects appear very dim that the Proposal can pass even a minimum threshold of any reasonable cost-benefit consideration. The vast costs the Proposal would impose if

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<sup>46</sup> See *Twenty-Year Review of Audit & Non-Audit Fee Trends* by Audit Analytics (October 2022).

<sup>47</sup> See, the “Effects of SOX 404(b) Implementation on Audit Fees by SEC Filer Size Category” by Michael Ettredge, Matthew Sherwood, and Lili Sun in the *Journal of Accounting and Public Policy* (January-February 2018), pages 21-38.

<sup>48</sup> See *Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates from a Sample of Fortune 1000 Companies* by Charles River Associates (April 2005), page 2.

enacted coupled with a clear lack of statutory authority to proceed, clearly raise issues under the major questions doctrine.<sup>49</sup>

### Recommendations

The Chamber strongly urges the PCAOB to withdraw and reconsider the Proposal. If the Board decides to proceed with a revised proposal on NOCLAR, the PCAOB needs to lay the ground-work for it.<sup>50</sup> In this regard, the Chamber has the following recommendations:

- Liaise with the IAASB and ASB. The more recently revised NOCLAR standards of each of these bodies have been in place long enough that the PCAOB's efforts can be informed by them. The PCAOB should interact with the IAASB and ASB to determine what is working well and what might be refined or improved on – while fit for purpose for audits of issuers and broker-dealers.
- Work with other regulators including the SEC and FASB to ensure that any PCAOB NOCLAR proposal aligns with regulatory requirements and U.S. GAAP.
- Use roundtables to solicit input and insights from all stakeholders, including auditors, companies, broker-dealers, audit committee members, lawyers, other specialists, and academics, along with investor representatives.<sup>51</sup>
- Use the PCAOB's Standards and Emerging Issues Advisory Group ("SEIAG") and/or form a special task force to bring the necessary relevant expertise and experience to inform the PCAOB process of developing an appropriate and tractable standard on NOCLAR.
- Field test proposed requirements during the development of a proposal to identify challenges, including ones related to implementation, and assess the reasonableness of provisions under consideration.

In addition to these recommendations, the Chamber strongly urges the PCAOB to reconsider its approach to specifying an effective date for this and other PCAOB proposals. An approach of using an effective date for a revised standard of audits of fiscal years beginning in

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<sup>49</sup> See, e.g., *West Virginia v. EPA*, 142 S. Ct. 2587, 2609 (2022), ("We 'typically greet' assertions of 'extravagant statutory power over the national economy' with 'skepticism'" (citing *Utility Air Reg. Group v. EPA*, 574 US 302, 324 (2014))).

<sup>50</sup> The PCAOB has issued concept releases to solicit public comment on potential new and consequential standard-setting projects in advance of considering whether to develop a proposal.

<sup>51</sup> For example, the PCAOB should solicit input from issuers and others on the costs of the Proposal, especially considering internal legal, compliance, and monitoring systems and activities at companies that the Proposal would require the independent auditor to duplicate as part of the financial statement (integrated) audit. Further, in conjunction with NOCLAR, roundtable discussions could include the PCAOB's midterm standard-setting agenda project on fraud.



the year after approval by the SEC (or fiscal years beginning two years after the year of SEC approval, if SEC approval occurs in the fourth quarter of a calendar year)<sup>52</sup> is unrealistic for such a consequential proposal. Further, with all the challenges, phased implementations for smaller audit firms may be necessary.

Moreover, given the flurry of consequential PCAOB standard-setting activities, the Chamber strongly urges the PCAOB to step-back and consider the effective dates and implementation of its revised standards from a holistic perspective, including their interaction effects. Implementing a significant number of new PCAOB requirements simultaneously (or nearly so) would be a complex challenge for audit firms of all sizes and very disruptive to the conduct of issuer and broker-dealer financial statement and ICFR (integrated) audits. Under its aggressive agenda to update and modernize its standards, the PCAOB needs to avoid undermining the market for audit services for public companies and broker-dealers.

### **Concluding Remarks**

In conclusion, the Chamber has very deep concerns about this Proposal and strongly urge the PCAOB to withdraw it. The Proposal is a far-reaching and costly departure from the auditor's core responsibilities for financial statement (integrated) audits – without adequate justification and consideration of the costs and consequences – and raises numerous issues of authority and regulatory policy. As it stands, the Proposal risks undermining the credibility of the PCAOB as a fair, reasonable, and proportionate audit regulator both in the U.S. and abroad.

Thank you for your consideration and we stand ready to discuss these matters with you further.

Sincerely,

A handwritten signature in black ink, appearing to read 'T. Quaadman', with a long, sweeping horizontal stroke extending to the right.

Tom Quaadman  
Executive Vice President  
Center for Capital Markets Competitiveness  
U.S. Chamber of Commerce

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<sup>52</sup> See the Exposure Draft, page 94.