

August 7, 2023

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

Re: PCAOB Rulemaking Docket Matter No. 051

Deloitte & Touche LLP (“D&T,” “we,” or “our”) appreciates the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (the “PCAOB” or the “Board”) on PCAOB Release No. 2023-003, *Proposing Release – Amendments to PCAOB Auditing Standards related to a Company’s Noncompliance with Laws and Regulations* (the “Proposal,” “proposed AS 2405,” or “the Release”).

Overall Summary

We support the Board’s ongoing efforts to modernize and improve its standards, particularly the interim standards as adopted upon the establishment of the Board. We also support the Board’s objective to clarify the auditor’s obligations regarding noncompliance with laws and regulations (“NOCLAR”), establish clear performance obligations and enhance the auditor’s risk assessments procedures related to NOCLAR. However, we believe that the Proposal contains elements that are impracticable to implement as further described in our letter and in the Appendix. We request that the Board consider revisions to proposed AS 2405 to address our observations, including our key concerns that the Proposal:

- Creates inconsistencies with the long-established accountability framework, where management is responsible for the preparation and fair presentation of the financial statements in accordance with an applicable financial reporting framework (e.g., US GAAP).
- Expands the scope of NOCLAR audit procedures to consider all laws and regulations to which an entity is subject, and significantly expands the information the auditor needs to obtain and review in order to evaluate the effect, if any, of noncompliance with those laws and regulations.
- Requires auditors to have legal acumen and expertise beyond their core competencies, and may create conflicts with the legal profession, including introducing risks that auditors may engage in the unauthorized practice of law.

Support of Enhancements to Auditor's Responsibilities on NOCLAR

We support the Board's objective of advancing audit quality in order to protect the interests of investors¹ and agree the existing PCAOB standard related to NOCLAR could be strengthened. This could be achieved through modernizing the existing PCAOB standard with certain targeted amendments. For example, the auditor could perform expanded inquiries with respect to NOCLAR, including inquiries with the chief compliance officer, and the auditor could review correspondence, if any, from regulatory authorities. The auditor could also obtain additional written representations from management or the audit committee regarding management's knowledge of identified or suspected NOCLAR.

In developing a final standard, we recommend the PCAOB host a roundtable or similar facilitated discussion with all key stakeholders to consider various hypothetical scenarios to assess the feasibility of amendments to existing AS 2405, *Illegal Acts by Clients* ("existing AS 2405"), and the impacts on the various stakeholders and current financial reporting and regulatory frameworks. This proposed approach may provide a clearer understanding to users of the financial statements of the integrated roles of stakeholders in identifying and disclosing NOCLAR and allow the Board to achieve its objective of advancing audit quality.

Key Concerns

Inconsistency with the Long-Established Accountability Framework

We believe that the Proposal contains an expansion of the auditor's responsibilities beyond those of management related to NOCLAR. It is not clear that the initial determination of whether noncompliance is likely to have occurred is the responsibility of management. In addition, proposed AS 2405 conflicts with management's assessment of ICFR as management's assessment is only inclusive of controls over the compliance with laws and regulations that are directly related to the preparation of the financial statements, whereas the scope of laws and regulations for which the auditor would be responsible for performing procedures and concluding on under the Proposal would be much broader. The Proposal has the potential to undermine the long-established accountability framework whereby management prepares and discloses financial information, auditors form an independent opinion on the financial statements and internal control over financial reporting ("ICFR"), when applicable, and regulators provide oversight of public companies and auditors.

Expansion of Scope of Laws and Regulations and Information Needed to Be Evaluated by the Auditor

While page 22 of the Release indicates that auditors would not be expected to identify "every law or regulation to which the company is subject," the Proposal does not clearly define "could reasonably have a material effect on the financial statements" nor does it provide a framework for the auditor to determine which laws or regulations would be expected to be identified.

¹ See pages 4 and 5 of the Release, which state, "The Board believes that improving standards can: (i) protect investors from the resulting harm of noncompliance with laws and regulations when the effect of such noncompliance has a material effect on the financial statements and (ii) improve audit quality through the auditor's identification of noncompliance with laws and regulations that could reasonably result in a material effect on the financial statements."

The Proposal also does not draw a discernable line as to what information the auditor is, and is not, required to identify, review, and evaluate in the search for possible NOCLAR. The absence of guideposts related to the expected nature and extent of information to be included would create challenges for most audits, and in particular would impact audits of large multinational companies, companies that have a significant online presence, and companies that receive significant media, analyst, or social media coverage. The volume of information that the Proposal would require auditors to locate and analyze as well as test the completeness and accuracy of in accordance with PCAOB Auditing Standard (“AS”) 1105, *Audit Evidence*, paragraph .10 would be impracticable given required report filing deadlines and resource constraints.

In addition, with the prevalence of alternative forms of media reporting, it could be particularly challenging for auditors to assess the reliability of certain publicly available third-party information, such as non-financial information from social media, without performing significant procedures on this information, such as confirmation. Auditors will also face challenges with determining how to consider and assess conflicting or purportedly “inaccurate” information.

New Expectations Outside of the Auditor’s Core Competencies

Existing AS 2405 paragraph .06 recognizes that auditors ordinarily do not possess legal skills and, therefore, cannot make legal judgments concerning information coming to their attention. We believe that the Proposal would change that principle and introduce the need for auditors to acquire legal competencies that would create conflicts with the legal profession.

We also note there are certain potential unintended consequences of the Proposal, including that it may:

- Create conflicts with existing standards and laws and regulations promulgated by other standard-setters and regulatory bodies.
- Widen the “expectation gap” for users of audited financial statements related to NOCLAR. For example, users may expect based on the Proposal that the auditor will be in a position to identify and conclude, with sufficient legal expertise, whether the entity has complied with every law and regulation to which it is subject. For a multinational company subject to thousands of national, regional, and local laws covering a myriad of legal areas (e.g., data privacy, human resources), the limitations of procedures an auditor could reasonably perform may not be well understood in the context of the Proposal.

Our Recommendations

- We recommend that the PCAOB perform further economic analysis on the impacts of the Proposal, including how the potential benefits outweigh the substantial costs, as we believe the Proposal does not sufficiently demonstrate how the potential benefits to investors outweigh the “substantial costs”² to companies, auditors, and ultimately investors. We are concerned that the PCAOB is establishing new auditor obligations and responsibilities in ways that will significantly expand the scope and cost of audits and fundamentally alter the role of auditors without a

² See page 76 of the Release, which states, “The Board recognizes that imposing new requirements would result in additional, potentially substantial costs to auditors and the companies they audit.”

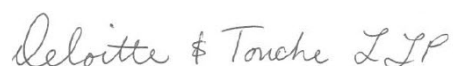
thorough evaluation of the associated costs versus the anticipated benefits.

- We recommend further collaboration among key stakeholders to align holistically on the transparency and reporting of NOCLAR including audit committees, US and global legal and regulatory communities, the Financial Accounting Standards Board (“FASB”), the Securities and Exchange Commission (“SEC”), and the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). We believe that standard-setters should work closely together to develop coordinated approaches to revise applicable standards to be responsive to the needs of investors. Changes to the applicable financial reporting framework (e.g., US GAAP), SEC rules and regulations, as well as auditing standards need to occur concurrently to mitigate conflicts among professional standards and regulations.
- We recommend that, after making amendments to proposed AS 2405 for the feedback received in the comment letter process and other outreach we have suggested above, the PCAOB consider reproposing AS 2405 to allow for a full and transparent vetting of the implications of changes made.
- In considering the effective date, should the PCAOB continue the project on its current timetable, we ask the Board to consider an effective date that contemplates the considerable amount of time that public accounting firms would require to implement this Proposal, including the amount of time companies and audit committees would require to prepare for related requests from auditors. In addition, we ask that the Board consider the other ongoing standard-setting projects that are expected to be adopted in the next year. With the pace of change, it is critical that public accounting firms have sufficient time to implement new and amended standards, including to effectively train professionals on new and amended auditing standards and Board rules in accordance with proposed Quality Control (“QC”) 1000, *A Firm’s System of Quality Control*.

We appreciate the opportunity to provide our perspectives on this important topic. We support the Board’s objective to advance audit quality through enhancing auditor’s obligations regarding NOCLAR in existing AS 2405. We respectfully request the PCAOB to give careful consideration to the observations raised in our comments about proposed changes, particularly where we have noted the impracticality of implementation.

These are complex and challenging topics that impact numerous stakeholders. We look forward to engaging constructively with the Board and other stakeholders to provide our perspectives to facilitate the issuance of final PCAOB auditing standards that will enhance audit quality. If you have any questions or would like to discuss these issues further, please contact Christine Davine at (202) 879-4905, Jennifer Haskell at (203) 761-3394, or Emily Fitts at (203) 423-4455.

Yours sincerely,



Deloitte & Touche LLP

Appendix

This Appendix is intended to provide additional context related to our concerns, as discussed above. The Appendix will also provide further observations on the Proposal within the [Other Matters](#) section.

Inconsistency with the Long-Established Accountability Framework

The Proposal introduces ambiguities regarding management and auditor's roles and responsibilities in the financial reporting ecosystem. We believe it is essential to well-functioning capital markets that auditors have clear roles and responsibilities that are independent of management to facilitate high-quality, reliable financial reporting in supporting the public interest. The areas below provide additional context related to our key observation above related to inconsistency with the long-established accountability framework.

Differences in the Scope of Internal Controls over Financial Reporting ("ICFR") for Reporting by Management and Auditor

The SEC staff in Question 10 of its frequently asked questions on *Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports*³ states "[t]he definition of the term 'internal control over financial reporting' does not encompass a registrant's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements."

Management's assessment is limited to controls over the compliance with laws and regulations that are *directly* related to the preparation of the financial statements. The Proposal causes a disconnect between the scope of management's requirements for ICFR and the scope of the auditor's responsibilities by eliminating the existing distinction between direct and indirect effects on the financial statements for the auditor. If the auditor's reporting responsibility is widened, it would likely impact and expand management's ICFR scope. That expansion for management would in turn expand an audit committee's responsibility to oversee the system of internal controls as it relates to compliance with law and regulations, including the audit committee needing to expand the scope of its confirmation that related controls are adequate and well-functioning.

The auditor's requirements related to controls should be grounded in management's assessment in accordance with AS 2201.01. Without a clear corresponding requirement for management to conduct an analysis of the universe of laws and regulations that may have an indirect effect on the financial statements, the application of proposed AS 2405 will be inconsistent and ineffective.

Inconsistencies with the Applicable Financial Reporting Framework

The Proposal causes a disconnect between the applicable financial reporting frameworks and the auditor's responsibilities under proposed AS 2405.

Under both the existing and proposed AS 2405, when NOCLAR (or illegal acts under existing AS 2405) has

³ Available at <https://www.sec.gov/info/accountants/controlfaq0604.htm>.

or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit. However, under proposed AS 2405, this assessment would be dependent on the auditor's determining whether it is likely that any such noncompliance occurred,⁴ which is outside the auditor's core competencies. Further, as explained below, the Proposal is not clear with respect to how the auditor would consider the potential impacts of qualitative factors such as reputational harm or declines in stock price in their assessment of whether NOCLAR could reasonably have a material effect, nor is it clear how their impacts would affect financial statements.

The Proposal also utilizes terminology such as "could reasonably," "may," "might," and "likely" that introduces ambiguities in the application of determining the effect on the financial statements in accordance with the applicable financial reporting framework, specifically Accounting Standards Codification ("ASC") 450, *Contingencies*. Proposed AS 2405 contains language that does not appear to be aligned with generally accepted accounting principles ("GAAP") in regard to the likelihood continuum for loss contingencies. For example, on page 32 of the Release, it states that management inquiry, by itself, "would not provide sufficient evidence that all instances of noncompliance that *could reasonably* have a material effect on the financial statements have been identified and properly presented in the financial statements in accordance with the applicable financial reporting framework." This statement in the Release regarding presentation of the financial statements related to "noncompliance that *could reasonably* have a material effect" introduces language such as "could reasonably" that ultimately does not align with the language in applying ASC 450, *Contingencies*.

These factors in the Proposal, taken together with the recent AS 1000 proposal, which expands the auditor's requirements to go beyond the financial reporting framework to determine whether the financial statements are "presented fairly" or "misleading to a reasonable investor," creates a tension between the existing applicable financial reporting frameworks and the PCAOB's proposed auditing standards with respect to recording contingencies and financial statement disclosures. This tension may result in increased confusion about the auditor's responsibility to consider whether recorded contingencies and disclosures in the financial statements related to possible NOCLAR are appropriate.

Expansion of Scope of Laws and Regulations and Information Needed to Be Evaluated by the Auditor

We are concerned that the Proposal may inhibit the auditor's ability to apply a risk-based approach, given the broad expansion of both the laws and regulations subject to audit procedures and the expansion in the nature and extent of information the Proposal suggests should be obtained and evaluated by the auditor. The auditor's attention may be pulled away from areas in which risks of material misstatement may be present in the pursuit of the work needed for NOCLAR under this scope expansion. The areas below provide additional context related to our key observation above related to the identification of laws and regulations and the expansion of the information the auditor obtains and evaluates.

Elimination of Distinction between "Direct" and "Indirect" Effects

We do not believe that the Proposal provides sufficient basis for eliminating the distinction between direct and indirect effect on financial statements, and that the distinction under existing AS 2405 is operable and aligned with management's responsibilities in accordance with applicable financial reporting

⁴ See proposed AS 2405.07.

and ICFR frameworks. Existing AS 2405 uses this framework because laws and regulations with direct effects on the financial statements have a “known relation to audit objectives derived from financial statement assertions.” That is, their impact on the financial statements is known, such as the impact of Organization for Economic Cooperation and Development’s (“OECD”) Global Anti-Base Erosion Model Rules (Pillar Two). Meanwhile, laws and regulations with indirect effects “relate more to an entity’s operating aspects than to its financial and accounting aspects.” As such, indirect effects are difficult to quantify as they are imbued with a wide range of uncertainties. For example, it would be difficult to quantify the effect of potential noncompliance with the Health Insurance Portability and Accountability Act (“HIPPA”) for a manufacturing company as the act is not derived from financial statement assertions and its effects on the financial statements are indirect.

We recommend the PCAOB retain the bifurcation between the auditor’s consideration of laws and regulations that have a “direct and material effect on the determination of financial statement amounts” and the consideration of laws and regulations whose violation would have only an indirect effect. We also recommend the PCAOB consider clarifying that the auditor’s identification of laws and regulations is based on the laws and regulations identified by management.

Consideration of Reputational Harm and Stock Price Declines

The Proposal is unclear about whether the auditor would consider the potential impacts of other quantitative and qualitative factors (such as reputational harm or stock price decline) in assessing whether noncompliance “could reasonably have a material effect on the financial statements.” The ambiguity is caused by the focus in the Release on the impact to investors related to reputational harm and company stock price declines. Specifically, page 65 of the Release states that “studies suggest that significant reputational loss is associated with noncompliance directly affecting stakeholders who engage in repeat business or have an ongoing relationship with a company (e.g., customers, suppliers, employees, or investors),” and “the decline in the company’s stock market value is shown to far exceed the expected legal and regulatory penalties.”

Auditor’s Use of Media Reporting Information

The Proposal would require the auditor to read publicly available information including “executive officer’s social media accounts” as well as “information from sources external to the company, such as media reporting,” without providing a limiting principle (such as the auditor’s professional judgment) on the amount or type of public information that would need to be reviewed.

Further, the Proposal does not define “media reporting” and without a clear definition it will be impracticable for an auditor to consistently comply with the requirement, especially given there are many nontraditional media outlets, including social media platforms and unaccredited publications, which may contain unverified, speculative, opinions about a company which nonetheless could be accurate.

Consideration of Whistleblower & Other Compliance Complaints

The Proposal suggests that the auditor would be expected to identify all information that might indicate instances of noncompliance with any law or regulation across the company’s operations, without regard to whether it has a direct and material effect on the financial statements. In addition, page 41 of the

Release states “... the auditor may identify or become aware of information indicating that noncompliance has or may have occurred ... through reading ... whistleblower reports ...” The Proposal suggests that the auditor is required to obtain and separately evaluate each whistleblower and other compliance complaint to identify a possible indication of noncompliance. We believe this is impracticable, as based on our experience, the range of whistleblower tips and other compliance complaints unrelated to financial reporting (such as Human Resource matters) for companies can range from hundreds to thousands on average a year.

New Expectations Outside of the Auditor’s Core Competencies

We are concerned that the Proposal creates new expectations of auditors that are outside their core competencies, including in their ability to make NOCLAR determinations. The areas below provide additional context related to this key observation.

Auditor Ability to Make NOCLAR Determinations

Proposed AS 2405.07 requires that where the auditor identifies that noncompliance with laws and regulations “has or may have occurred,” the auditor “must ... determine whether it is likely that any such noncompliance occurred,” which is a substantial increase in auditor responsibility. To make such a determination, the auditor would be required to make legal judgments about issues that are beyond their competency and training. Further, the determination as to whether there is noncompliance is ultimately a matter for legal determination such as by a court or other appropriate adjudicative body, which is outlined in existing AS 2405. These legal judgments also would, in numerous cases, be highly subjective and would require making assumptions that are subject to uncertainties inherent in all matters of compliance issues. Therefore, we believe requiring auditors to make this determination is impracticable.

The Proposal also does not appear to have addressed some practical considerations that would arise on a regular basis if the auditor were to take on this legal compliance burden. For example, auditors would likely be confronted with situations in which private plaintiffs allege noncompliance by a company based on novel legal theories that had not previously been part of the company’s or auditor’s legal analysis. The Proposal does not address this type of situation along with the significant increased scope of the auditor’s responsibilities that are outside their core competencies, including the resources and timing needed to comply with the new requirements. This further demonstrates, in addition to the considerations above, how proposed AS 2405 is disconnected with the applicable financial reporting framework, where currently, the company and then subsequently the auditor would assess whether any new litigation is probable and whether a loss contingency is necessary in accordance with the applicable financial reporting framework.

Expansion of the Need for Legal Expertise and Other Experts

The expansion of the need for legal expertise will also result in resource constraints for both auditors and management. As an example, related to environmental laws and regulations a company is subject to, auditors would be required to engage specific environmental legal specialists (most likely multiple legal specialists if the company is multinational) to understand the laws and regulations the company is subject to, as well as fraud specialists to understand potential fraud schemes related to environmental laws and

regulations in order to obtain an appropriate understanding and inform their assessment of potential noncompliance.

Different specialists would also be needed for other areas of laws and regulations, such as workplace safety, tax, and others. For a large multinational company subject to a vast array of laws and regulations, including numerous foreign jurisdictions, there could be significant challenges in identifying and retaining specialists in all such fields and jurisdictions. There will also be challenges with obtaining legal specialists when considering the impact of lawyer's abilities to serve various companies as a result of requirements to perform their own business conflict analyses to mitigate potential conflicts of interest.

These factors demonstrate that there are likely not enough qualified specialists in the marketplace to meet the requirements of the Proposal or it would be impracticable to engage them timely.

Consideration of Legal Privilege

The Proposal does not address several areas related to legal privilege that affect the practicability of proposed AS 2405, including:

- The implications of proposed AS 2405 in varying jurisdictions where regulations may be in place on lawyers regarding legal privileges and the use of their work.
- The company's ability to assert legal privileges and whether a company would need to waive applicable privileges given the increased sharing of information between the company and the auditor.
- The implications to the current limitations on lawyer's responses to auditors as outlined in AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* ("AS 2505" or "existing standard"). Attached to AS 2505 is the agreement between the AICPA and the American Bar Association, *American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (the "ABA agreement")*, which states, "it is appropriate for the lawyer's response" to an auditor's request for disclosure of loss contingencies of a client to be "limited to items which are considered individually or collectively material to the presentation of the client's financial statements."

Proposed AS 2405 would result in the auditor needing to obtain information from a registrant's lawyer regarding any matter that could reasonably have a material effect on the financial statements. Therefore, proposed AS 2405 results in an apparent contradiction between the ABA agreement and AS 2505. If the agreement and existing standards are not amended, it is likely that lawyers will not respond to the auditor's request to include matters that "could reasonably have a material effect on the financial statements," which would result in auditors not being able to obtain sufficient appropriate audit evidence.

We recommend the Board consider engaging broadly with the US and global legal community to further evaluate practical challenges and restrictions associated with legal privilege, in particular as it relates to matters outside of the US.

Other Matters

In addition to our key observations, we have additional observations regarding the Proposal.

Expanded Responsibilities for Audit Committees

The Release does not sufficiently address the impact of proposed AS 2405 on audit committees, including the increased communication by auditors on NOCLAR to audit committees and whether audit committees would need to engage legal experts. As the auditor's requirements to identify laws and regulations extend beyond financial reporting, a company may need to reconsider its audit committee charter or restructure its governance bodies to align the mandates of those bodies with the nature of information the auditor would be expected to communicate under the Proposal.

In addition, page 50 of the Release emphasizes that “[a]uditors themselves would have to make most required communications, rather than simply assuring themselves that the audit committee is adequately informed, as is the current requirement under existing AS 2405.17.” While the Release indicates that auditors would not need to have duplicative communications with audit committees, “the proposed standard emphasizes that the auditor would be required to communicate any information that management omitted, was incomplete, or was inadequately described regarding the noncompliance to the audit committee. In determining what information is necessary to communicate to the audit committee, the auditor should consider the adequacy of the information communicated by management.”

Because the auditor is not involved in every conversation between management and the audit committee, to meet the requirements in the Proposal, it is likely the auditor will either need to be involved in more discussions between management and the audit committee or repeat information already shared by management to ensure the communication was complete and adequately described. Therefore, as described on page 85 of the Release, “the audit committee may expend time and resources addressing relatively minor instances of noncompliance when other matters may warrant more attention, rather than taking additional time to evaluate all matters appropriately.”

Evidence from Relevant Regulatory Bodies

An illustrative example included in the Release highlights that auditors could assess if there have been instances of noncompliance with laws and regulations by obtaining “reports from relevant regulators about the company.” Specifically, the Release states on page 22 that an auditor of a chemical company may identify information about environmental regulations and could obtain reports from relevant regulators related to environmental regulations about the company and understand how the company used those reports in their processes.

The auditor may have limited ability to consistently and timely obtain and evaluate information from regulators to satisfy its audit response to an identified risk of noncompliance. The inability to receive the requested information may lead to scope limitations or delays in filing of financial statements, which could result in destabilization of the capital markets.

We recommend the Board consider the feasibility of obtaining regulatory correspondence, in particular as it relates to matters outside of the US.

Change the Auditor's Duty to Consider Other Information

Proposed AS 2405.09(b) is inconsistent with the auditor's obligations under AS 2710, *Other Information in Documents Containing Audited Financial Statements*, which limits the auditor's responsibilities for documents containing the audited financial statements. AS 2710.04 states, "The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document."

In contrast, proposed AS 2405.09(b) requires the auditor to perform additional procedures to determine whether the noncompliance results "in other information in documents containing audited financial statements, or the manner of its presentation, being materially inconsistent with information appearing in the financial statements or containing a material misstatement of fact."

If the PCAOB believes an expansion of auditor responsibilities related to "other information" is appropriate, we suggest that the Board add an "other information" project back to the Board's standard-setting agenda and any potential expansion of the auditor's obligations should be considered as part of that project.