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Via email to comments@pcaobus.org

Office of the Secretary, PCAOB
1666 K Street, NW
Washington D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 51 Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments

Dear Secretary Brown and Members of the PCAOB:

I appreciate the opportunity to provide feedback to the Board regarding the proposed standards for a company's noncompliance with laws and regulations (NOCLAR). I am an accounting professor at Case Western Reserve University. I teach auditing and conduct research in the areas of auditor judgment and decision making and audit regulation.

Overall, I support the Board's efforts to update the interim auditing standards that were adopted at the PCAOB's inception. However, I do **not** support the proposed expansion of the scope of financial statement audits to identify NOCLAR that might have an indirect effect on the financial statements.

Audits of financial statements do not provide absolute assurance that financial statements are free of material misstatement for several reasons. One reason that audits do not provide absolute assurance is that auditors are not required to test 100% of the population of transactions. As a result, there is always a risk that the sample selected by the auditor is not representative of the population. In other words, the sample selected by the auditor may be free of misstatements even though misstatements exist in the population. If auditors tested 100% of the population of transactions, audits would provide a greater degree of assurance, but the cost of an audit would be astronomical. Thus, auditors sample transactions and, instead of looking for every misstatement, they focus on finding misstatements that would affect an investor's buy-hold-sell decision (i.e. material misstatements).

A similar approach is taken with respect to audits of internal control over financial reporting (ICFR). The auditor does not design the audit of ICFR to detect every internal control deficiency, but instead searches for the most severe internal control deficiencies, material weaknesses. While investors might benefit from the identification of every internal control deficiency that exists, the cost of an ICFR audit designed to detect every internal control deficiency would be astronomical. Thus, AS 2201, *An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements*, requires the auditor to use a top-down approach to focus on “accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures.”

The extant standard AS 2405, *Illegal Acts by Clients*, takes a similar cost/benefit approach to the auditors’ responsibility for NOCLAR. The extant standard appropriately focuses the auditor’s procedures on those illegal acts that would “have a direct and material effect on the determination of financial statement amounts.” The distinction between direct and indirect illegal acts is necessary so that the cost of an audit does not exceed its benefit. A requirement for the auditor to design procedures to identify any illegal act that “could reasonably have a material effect on the financial statements” would increase the cost of an audit above its benefit.

Although the extant standards do not require the auditor to design and perform procedures to detect every illegal act that might occur, the standards do require auditors to perform various procedures that would bring illegal acts to their attention. For example, auditors are required to do the following:

- inquire of management regarding the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims and assessments (AS 2505.05).
- obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on (AS 2505.05).
- examine documents in the client’s possession concerning litigation, claims and assessments, including correspondence and invoices from lawyers (AS 2505.05).
- inquire of management and the audit committee concerning the client’s compliance with laws and regulations as well as their knowledge of violations or possible violations of laws and regulations (AS 2405.08)
- obtain written representations from management concerning the absence of violations or possible violations of laws or regulations (AS 2405.08 and 2505.05).
- request management to send a letter of inquiry to the lawyers with whom management has consulted concerning litigation, claims, and assessments (AS 2505.06).
- read minutes of meetings of stockholders, directors, and appropriate committees (AS 2505.07)
- read contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents (AS 2505.07)

Although the preceding list is not comprehensive, it does illustrate that the auditor performs a significant number of important procedures that can help to identify instances of NOCLAR. Once NOCLAR is identified, the extant standards require the auditor to evaluate the financial statement implications and communicate the information to appropriate parties within the entity. Also, the

requirements in the extant standard are aligned with the requirements of Section 10A of the federal securities laws.

It is very important to recognize that auditors are not trained in the law. The legal education of most accountants is one or two undergraduate courses in business law. Those courses tend to focus on the basics of contract law and other basic information covered on the CPA Exam. These courses do not put the auditor in the position to identify all of the potential laws and regulations with which their clients are required to comply. Therefore, in order to comply with the proposed standard, I believe auditors would need to engage an attorney as a specialist on every audit engagement and that the cost of doing so would exceed the benefit to investors.

I understand that investors have been adversely impacted when companies such as Wells Fargo are required to pay substantial fines as a result of NOCLAR. Congress or the SEC could consider whether to require issuers to engage lawyers to create an inventory of all applicable laws and regulations and evaluate whether there have been any instances of noncompliance with those laws and regulations in their annual report on Form 10-K. I believe that the benefit of such a requirement would be far below its cost. My point, however, is that the PCAOB is not the appropriate entity to impose this cost on our capital markets.

In summary, I urge the Board to retain the existing distinction between direct and indirect NOCLAR and related requirements. The costs imposed by the proposed standard will greatly exceed the benefit and widen the expectation gap. Thank you for the opportunity to comment on the proposed standard. If you have any questions, please contact me at 216-368-8895.

Sincerely,

/s/ John D. Keyser
John D. Keyser, PhD, CPA
Assistant Professor

Enclosure

Responses to Specific Questions

1. Is the proposed definition of “noncompliance with laws and regulations” sufficiently clear? If not, why not?

The proposed definition is “An act or omission, intentional or unintentional, by the company whose financial statements are under audit, or by the company’s management, 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.”

I believe that the definition is sufficiently clear. However, I am concerned that it is unreasonable to expect that auditors, who are not trained in the law, would be expected to be able to design audit procedures to detect every instance of noncompliance under this definition. If the PCAOB retains the extant concept of direct and indirect, then the definition would be appropriate.

2. Is the rationale for including fraud, as described in AS 2401, within the proposed definition of noncompliance with laws and regulations sufficiently clear? If not, why not?

No. I do not think anyone would disagree with the assertion that fraud is illegal. The auditor has specific responsibilities for the detection of material misstatements due to fraud as outlined in AS 2401, *Consideration of Fraud in a Financial Statement Audit*. I believe that the auditor’s responsibility for financial statement fraud should be higher than his or her responsibility for NOCLAR because financial statement fraud has a direct impact on the financial statements. The auditor should be required to design and perform procedures to detect fraud that could result in a material misstatement of the financial statements. Misappropriation of assets and fraudulent financial reporting are areas where the auditor has expertise. In contrast, the vast majority of auditors do not have expertise in the law and so their responsibility for the detection of non-financial-statement-fraud NOCLAR should be lower. I do not agree with including financial statement fraud in the definition of NOCLAR.

3. Is additional clarification necessary regarding the scope of the meaning of a company’s noncompliance with laws and regulations? If so, please describe or provide examples of the types of noncompliance where additional clarification is needed.

I don't think additional clarification is necessary. However, please see my response to Questions 1 and 2.

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

No. The introduction is not sufficient clear. Since there is a separate standard that details the auditor's responsibility for fraud, it is potentially confusing to include fraud as a subset of NOCLAR in the first paragraph. The auditor's responsibility for material misstatements due to fraud is appropriately described in AS 2401, *Consideration of Fraud in a Financial Statement Audit*. Including discussion of fraud in this standard only conflates the auditor's responsibility for fraud with that for non-fraud NOCLAR.

The PCAOB should retain the existing distinction between direct and indirect NOCLAR and that concept should be included in the introduction section.

The introduction includes a new threshold, "could reasonably have a material effect" that is ambiguous and undefined. A more appropriate and understandable threshold would be "probable that it would result in a material misstatement."

5. **Are the objectives for proposed AS 2405 sufficiently clear? If not, how should the objectives be clarified?**

No. The first objective is to create an inventory of laws and regulations with which the auditee is required to comply. This objective places an unreasonable expectation on the auditor who is not a lawyer. In order to meet this objective, every audit would require the use of an internal or external specialist to create the inventory of applicable laws and regulations. The cost of creating this inventory will greatly exceed the benefit.

The second objective is to design audit procedures to detect any instances of noncompliance with the inventory of laws and regulations created to meet the first objective. Since the auditor is not a lawyer, it will be necessary for the auditor to use a specialist to evaluate whether the auditee is in full compliance with the inventory of applicable laws and regulations.

The third objective is to identify instances of noncompliance. Again, the determination as to whether an entity is in compliance with an applicable law or regulation is a legal determination typically made by courts. This objective falls outside the accountant's training. Under the extant standards, the auditor obtains information about noncompliance from management's in-house and

external legal counsel who have expertise in the law and full knowledge of the facts. Auditors may not be privy to facts relevant to potential noncompliance due to attorney-client privilege.

The fourth objective might be more clear if it specified the recipient of the communications. I suggest rewriting the fourth objective as follows:

When the auditor identifies or otherwise becomes aware of information indicating that instances of noncompliance have or may have occurred, evaluate ~~and communicate~~ such instances of noncompliance *and assure that the appropriate parties (e.g., management, audit committee, board of directors) are adequately informed of the facts or allegations known to the auditor.*

6. Are there other objectives that should be included in proposed AS 2405? If so, what would those objectives be?

No.

7. Is the proposed requirement for auditors to identify laws and regulations applicable to the company with which compliance could reasonably have a material effect on the financial statements sufficiently clear? If not, why not?

No. Auditors generally have no legal education, other than one or two undergraduate courses in business law. It is not practical for an auditor to (1) identify the laws and regulations that may be applicable to the auditee and (2) determine which of those laws and regulations could reasonably have a material effect on the financial statements.

Extant AS 2405 appropriately recognizes that “an auditor ordinarily does not have sufficient basis for recognizing possible violations of” the various laws and regulations applicable to the auditee. The proposed standard fails to recognize this important fact.

8. Will auditors be able to identify those laws and regulations applicable to the company with which compliance could reasonably have a material effect on the financial statements? If not, why not?

No. Auditors have no legal training and are, therefore, not in a position to make judgments about what laws and regulations apply to a particular entity or whether noncompliance with a particular law could result in fines or penalties that would be material to the financial statements. Evaluation of legal compliance is the role of attorneys.

- 9. Are there additional procedures that should be required for auditors to perform to identify those laws and regulations applicable to the company with which noncompliance could reasonably have a material effect on the financial statements? If so, describe.**

No. The auditor should be required to design and perform procedures to detect NOCLAR that would have a direct and material effect on the financial statements. The auditor's responsibility for the detection of indirect effect NOCLAR should be (a) inquiry of management and the audit committee regarding alleged, suspected, or known instances of noncompliance; (b) inspection of board of director minutes and audit committee minutes; (c) inquiry of in-house legal counsel; (d) inspection of legal invoices; (e) inspection of regulatory reports; and (f) confirmation letters to external legal counsel. The auditor should not be required to create an inventory of laws and regulations applicable to the entity and then test each law and regulation for compliance.

- 10. Is the proposed requirement for auditors to assess and respond to the risks of material misstatement due to noncompliance with laws and regulations sufficiently clear? If not, why not?**

No. The Board is proposing to eliminate a standard that has worked (i.e. direct versus indirect) with a new standard that is less clear and so onerous that it will greatly increase the cost of audits without a corresponding benefit to investors.

- 11. Is the proposed requirement that auditors identify whether there is information indicating that noncompliance (with those laws and regulations with which noncompliance could reasonably have a material effect on the financial statements) has or may have occurred sufficiently clear? If not, why not?**

No. The auditor should be required to design and perform procedures to detect NOCLAR that would have a direct and material effect on the financial statements. The auditor's responsibility for the detection of indirect effect NOCLAR should be (a) inquiry of management and the audit committee regarding alleged, suspected, or known instances of noncompliance; (b) inspection of board of director minutes and audit committee minutes; (c) inquiry of in-house legal counsel; (d) inspection of legal invoices; (e) inspection of regulatory reports; and (f) confirmation letters to external legal counsel. The auditor should not be required to create an inventory of laws and regulations applicable to the entity and then test each law and regulation for compliance.

- 12. Are there other specific procedures the auditor should be required to perform to assist them in identifying whether there is information indicating that noncompliance (with**

those laws and regulations with which noncompliance could reasonably have a material effect on the financial statements) has or may have occurred? If so, what are those procedures?

No.

- 13. Are there other examples of procedures which might assist the auditor in identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements or alert the auditor to information indicating that noncompliance has or may have occurred that should be included? If so, what are they?**

No. In fact, the examples provided demonstrate that the proposal goes too far. The idea that the auditor would test controls over compliance with FCPA and test cash disbursements looking for potential bribes is far beyond the scope of what should be required for a financial statement audit. The proposed requirements will increase the cost of audits far beyond any benefit to investors.

- 14. Are there other procedures that auditors perform today that should be required to assist the auditor in (1) identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, (2) assessing and responding to risks of material misstatement due to noncompliance with those laws and regulations, or (3) identifying information indicating that noncompliance with those laws and regulations has or may have occurred? If so, what are they?**

No.

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

I am not aware of any such procedures designed specifically to detect NOCLAR.

- 16. Is the proposed approach to include the requirements related to understanding (1) the laws and regulations that govern the determination of the form and content of the financial statements and (2) those other laws and regulations with which the company's noncompliance could reasonably have a material effect on the financial statements sufficiently clear? If not, why not?**

No. It is appropriate for the auditor to obtain an understanding of the laws and regulations that govern the determination of the form and content of the financial statements. In general, this is referring to SEC Regulation S-X, but also would include other regulations for particular industries. For example, the banking industry faces various regulations including the determination of regulatory capital and the calculation of the allowance for loan losses.

However, it is not clear how the auditor would identify “those other laws and regulations with which the company’s noncompliance could reasonably have a material effect on the financial statements.” Accountants generally have not received legal training and thus, are ill equipped to identify all the other laws and regulations that apply to any particular auditee.

17. Is the proposed approach to include the requirements related to understanding management’s related processes for identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements and for preventing, identifying, investigating, evaluating, and communicating compliance in AS 2110 sufficiently clear? If not, why not?

Some auditees have employees or entire departments that focus on compliance matters. It is reasonable for the auditor to inquire regarding the qualifications of these employees and to inquire as to whether they suspect or know about instances of noncompliance with applicable laws and regulations.

I am concerned about scalability of this requirement because smaller issuers may not have employees focused on compliance and instead rely on internal or external legal counsel. The auditor should be able to satisfy the requirement to identify indirect effect NOCLAR through inquiry of, and written communication from, the auditee’s legal counsel.

18. Are the proposed requirements related to reading publicly available information about the company sufficiently clear? If not, why not?

No. It is unreasonable to require the auditor to search the Facebook, Instagram, TikTok, and Twitter accounts of a company’s executives to search for potential inadvertent disclosure of NOCLAR.

19. Are the proposed additional requirements in AS 2110 regarding inquiries of others within the company sufficiently clear? If not, why not?

The requirements to inquire of management, audit committee, and internal audit personnel about instances of NOCLAR is appropriate. However, the inquiries should also be directed to in-house legal counsel and the compliance department, if applicable.

- 20. Is the requirement to inquire about whether correspondence exists with the company's relevant regulatory authorities regarding instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations that could reasonably have a material effect on the financial statements and the nature of such correspondence sufficiently clear? If not, why not? Would this requirement change auditors' current practices of communicating directly with regulators about the company when appropriate and necessary? If so, how?**

It is appropriate for the auditor to inquire regarding any correspondence with regulatory authorities regarding NOCLAR and related fines and penalties. I believe these inquiries are already being made and have been made as part of audits for a long time.

- 21. Are there other examples of the application of procedures that should be included for clarity? If so, please describe those examples.**

No.

- 22. Are the proposed requirements and examples regarding understanding changes to the company's operating strategy and the impact on the company's accounting principles and disclosures sufficiently clear? If not, why not?**

Yes. It is reasonable for auditor's to consider whether changes in the company's operating strategy might provide contradictory evidence about assumptions used to develop estimates for various accounts such as inventory obsolescence and goodwill impairment. However, it is less clear how the auditor would use this information to identify new laws and regulations applicable to the entity. Identifying new applicable laws and regulations should be the purview of the company's legal counsel. The auditor already is required to inquire of legal counsel regarding unasserted claims and assessments. That inquiry should be sufficient for this purpose.

- 23. Are there additional procedures the auditor should be required to perform to identify noncompliance with laws and regulations that are not currently contemplated by the proposed amendments? If so, what are the procedures?**

No.

24. Is the proposed approach to evaluate instances of noncompliance that has or may have occurred sufficiently clear? If not, why not?

Yes. The proposed approach to evaluate instances of noncompliance that has or may have occurred is sufficiently clear.

25. Is the proposed requirement for auditors to consider whether specialized skills or knowledge is needed to assist the auditor in evaluating noncompliance that has or may have occurred sufficiently clear? If not, why not?

No. The extant AS 2405 requirement to consult with specialists when management does not provide satisfactory information should be adequate. The auditor should not be required to engage legal counsel any time there is an instance of NOCLAR. Attorneys have a public interest responsibility as officers of the court. For example, if an attorney is aware of an unasserted claim that should be disclosed in the financial statements, and his or her client refuses to disclose the unasserted claim, the attorney is required by professional ethics to resign from the client. Auditors should be able to rely on information received from the auditee's legal counsel.

26. Are the procedures the auditor may perform to obtain an understanding of the nature and circumstances of potential noncompliance and to determine whether it is likely the noncompliance occurred sufficiently clear? If not, why not? What additional procedures, if any, should be added?

Yes.

27. Are there other procedures that the auditor should be required to perform when evaluating information indicating that noncompliance with laws and regulations has or may have occurred? If so, what are those procedures?

Yes. The auditor should always be required to inquire whether there have been any changes in legal counsel. This would alert the auditor to situations where legal counsel has resigned due to their client's refusal to disclose information about unasserted claims that would have a material effect on the financial statements.

28. When evaluating information that may be indicative that noncompliance has or may have occurred, should the auditor consider the impact of that information on other information in documents containing the audited financial statements? If not, why not?

Yes. The auditor's responsibilities with respect to other information included in financial statements is outlined in AS 2710. According to AS 2710.05, "If, while reading the other information for the reasons set forth in paragraph .04, the auditor becomes aware of information that he believes is a material misstatement of fact that is not a material inconsistency as described in paragraph .04, he should discuss the matter with the client." [...] "If, after discussing the matter as described in paragraph .05, the auditor concludes the material misstatement of fact remains, the action he takes will depend on his judgment in the particular circumstances."

29. Is the proposed requirement to determine whether senior management has taken timely and appropriate remedial action, including any impact on the auditor's report sufficiently clear? If not, why not?

The proposal is for the auditor to make a judgment about whether management has remediated noncompliance timely and if not, to withdraw. The proposal suggests that withdrawal would be necessary "even if the illegal act is not material to the financial statements." It is not clear what is meant by timely. For example, does the clock begin when the noncompliance occurs or when the noncompliance is discovered by senior management? Does materiality matter when evaluating the timeliness of the remediation?

30. Are the proposed communication requirements sufficiently clear? If not, why not?

No. It is not clear whether auditors must immediately communicate any allegation of NOCLAR regardless of the credibility of the allegation. The requirement to immediately communicate could result in the auditor communicating the NOCLAR to the perpetrator, tipping them off and making it more difficult to investigate. It seems likely that this requirement could have unintended consequences that are not in the best interest of investors.

31. Should the auditor's communication requirements differ when the information about noncompliance is identified by management, as compared to when identified by the auditor? Would the proposed exceptions for previous communications help in avoiding duplicative communications? Should the auditor communications be expanded or narrowed? If so, how?

The extent requirement for the auditor to assure themselves that the audit committee is adequately informed is more appropriate than a requirement for the auditor to provide duplicative communication to the audit committee. The auditor should, of course, communicate information corrects inaccurate or omitted information provided by management.

32. Are there any additional matters related to noncompliance with laws and regulations that should be communicated to management and the audit committee? If so, what?

No.

33. Does the timing of the proposed communications (that is, “as soon as practicable”) to management and the audit committee pose any particular challenges to the auditor? If so, how should the proposed requirement be changed?

Yes, as discussed above: The requirement to immediately communicate could result in the auditor communicating the NOCLAR to the perpetrator, tipping them off and making it more difficult to investigate. It seems likely that this requirement could have unintended consequences that are not in the best interest of investors.

34. Is it appropriate to require the auditor to have a subsequent communication to management and the audit committee to communicate the results of the auditor’s evaluation of information indicating noncompliance with laws and regulations has or may have occurred? If not, why not? Does this communication pose any particular challenges? If so, what are they?

It is management’s responsibility to identify NOCLAR and determine the impact on the financial statements including measurement of contingent liabilities and disclosure of relevant information. The existing required audit committee communications should be sufficient with regard to NOCLAR that is reflected in the financial statements.

35. Does the requirement to communicate the results of the auditor’s evaluation of information indicating noncompliance with laws and regulations has or may have occurred pose any particular challenges? If so, how should the proposed requirement be changed?

No.

36. Are there other communications the auditor should make (for example, to the PCAOB or other regulatory body, investors, other stakeholders)? If so, what should those communications include and who should those communications be made to?

No. The auditor should not be responsible for communicating legal matters to third parties. That should be the role of management, the board of directors, and the company’s legal counsel.

40. Should the proposed standard include a requirement for communication in the engagement report regarding specific aspects of a company's noncompliance with laws and regulations? If so, what should the communication include?

No. The auditor should not usurp the role of management in the communication of information to investors. The auditor should not be the source of original information about the entity. Management is already required to disclose legal matters in the 10-K. The auditor should not report on NOCLAR in the auditor's report.

50. Should an interim review requirement be added for the auditor to make specific inquiries regarding the company's ongoing investigations related to noncompliance with laws and regulations? If so, what should those specific inquiries be?

No.

51. Is rescinding AS 6110 appropriate? Does this standard continue to be used by auditors? If so, what are the specific provisions that are used by auditors and when is this standard used?

Yes. The standard is not relevant to audits of issuers or broker dealers.

52. Is rescinding AI 13 appropriate, or does the interpretation contain specific guidance necessary to apply PCAOB standards? If so, what is that specific guidance?

Yes.

53. Is rescinding AI 21 and replacing its content with a footnote in AS 2805 appropriate? If not, why not?

Yes.

54. Are there other changes that should be made to AS 2805? If so, what are those changes?

None that I am aware of.