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

BY ELECTRONIC SUBMISSION
Re: PCAOB Rulemaking Docket Matter No. 051

Dear Secretary Brown and Members of the Public Company Accounting Oversight Board:

I am pleased to provide these comments on the proposed amendments to the PCAOB's auditing standards related to a Company's noncompliance with laws and regulations and other related amendments.

By way of introduction, I am a long-time institutional investor who has been the investment manager or fiduciary for more than \$100 billion in assets. I also serve, and have served, in other roles with other responsibilities in the accounting and auditing ecosystem. For example, I chair the audit committee of the Van Eck family of Mutual Funds and Insurance Trusts. I am a member of Deloitte's Audit Quality Advisory Committee (AQAC), and the PCAOB's Standards and Emerging Issues Advisory Group (SEIAG). I was formerly a member of the PCAOB's Standing Advisory Group (SAG) and CPA Canada's Foresight Group. What follows are my personal opinions; nothing in this submission should be taken to mean that any member of Deloitte's management or the AQAC or the members of the AQAC, Van Eck, the SEIAG or the PCAOB or their members, or CPA Canada necessarily agree with any of my comments. They are solely my own opinions.

STATEMENT OF SUPPORT

Some twenty years ago, I served as a member of both the WorldCom and Adelphia official creditors' committee, two of the biggest frauds and bankruptcies in history. I was also involved as a member of a litigation trust for LeNature's, following a bankruptcy which resulted from a smaller "run of the mill" inventory fraud; a major asset of the trust was a claim against the auditor.

I believe the external auditors could have – and should have -- found those three instances of noncompliance long before they destroyed the companies, harmed investors, and, in the case of WorldCom and Adelphia, harmed the economy. Apparently the United States Congress thought so as well: Those instances of noncompliance and the auditors' failures to detect them earlier were direct motivations for the passage of the Sarbanes Oxley law, which, among other provisions, created the

PCAOB.¹ Clearly noncompliance was, and should still be, at the heart of investors' and policy-makers' concerns around audit quality.

I also note something that gets overlooked: The real world accountability that gets imposed on auditors when they fail to discover instances of noncompliance that later explode the financial statements. In every one of those cases, 1) the creditors, regulator and/or trustee sued the auditor, 2) the auditor initially made various arguments as to why it was not responsible or could not have found the instance of noncompliance, and 3) ultimately the auditors paid material amounts to settle the issue.² While those settlements may not have included an admission that the auditors were responsible for the failure to uncover the fraud, I believe that any objective observer would believe that was the case de facto, if not de jure. Few entities choose to pay tens or hundreds of millions of dollars if they truly were not responsible.

However, as the PCAOB proposal notes, there still seems to be a lack of clarity as to the audit profession's responsibility for uncovering noncompliance by designing the audit to detect fraud and noncompliance (at a reasonable level of assurance) and for performing audit procedures reasonably designed to detect non-compliance. That confusion creates negative real world impact: Only 4% of all frauds are uncovered by external auditors. That is less than the 5% that is uncovered by accident, and much less than the 12% uncovered by management review, the 16% revealed by internal audit or the 42% found through tips.³

Let me be clear. Where we are today is not adequate. It's not even in the neighborhood of adequate. I strongly support the expansion of auditor responsibility to consider instances of noncompliance and their potential impact on the financial statements whether those impacts are direct or indirect. Simply put, investors want two things from an audit: to know that the numbers are right, and to know that there was no fraud or noncompliance that will explode the financial statements and market value when it becomes public.

Audit firms must do more to make sure that noncompliance does not create errors in financial statements. That view is widely held by investors. A 2018 CFA Institute report found that 93% of all investors said that "auditor consideration of noncompliance with laws and regulations" should be a priority for the PCAOB, including 73% who said it should be a high priority.⁴ Clearly, investors perceive a need for improvement.

¹ Testimony concerning implementation of the Sarbanes Oxley Act, William H. Donaldson, SEC Chair, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, September 9, 2003.

² Arthur Andersen paid \$65 million in a settlement related to Worldcom (<https://www.nytimes.com/2005/04/25/business/andersen-to-settle-worldcom-lawsuit.html>; accessed August 1, 2023); Deloitte & Touche paid \$50 million in a settlement related to Adelphia (<https://www.sec.gov/news/press/2005-65.htm>, accessed August 1, 2023), BDO paid creditors to settle their claim in the LeNature' situation (<https://www.goingconcern.com/accounting-news-roundup-internal-controls-get-some-love-kozlowskis-setback-bdos-lenature/>, accessed August 1, 2023.)

³ "Occupational Fraud: Report to the Nations 2022", Association of Certified Fraud Examiners

⁴ "CFA Member Survey Report: Audit Value, Quality and Priorities." 2018. I note that this was the third highest priority out of 13. The only two which ranked higher both had to do with independence standards.

Yet the industry continues to talk about an “expectation gap”, which it claims “refers to the difference between (1) what the public and other financial statement users perceive auditors’ responsibilities to be and (2) what auditors believe their responsibilities entail.”⁵ This clever phrase makes it seem as if the limited accountability public audit firms assert for discovering, evaluating and communicating noncompliance is, at best, a misunderstanding between the auditors and the users of the financial statements. At worst, it is blaming the victim. In reality, it’s time to retire the phrase “expectation gap” and call it what it really is: A performance gap.

This proposal moves public auditing in the right direction. By directing auditors to consider noncompliance that could reasonably have a material impact on the financial statements, eliminating the somewhat arbitrary distinction between whether that impact is caused directly or indirectly on the financial statements, the proposal tries to restore the accountability of auditors to discover reasonable impacts of noncompliance that can materially affect the financial statements. The fact that public auditors do not now treat indirect causes of material harm to the financial statements the same way as direct causes will come as a surprise to many, if not most investors and financial market participants. Many assume that the risk assessment policies of a public auditor already cover both direct and indirect instances of noncompliance. After all, AS 1001 notes that “The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.” And AS 2110 requires the auditor to understand the regulatory and legal environment of the issuer, similar to the requirement in this proposal. No wonder there are the loud cries of “where was the auditor” when a situation like the Wells Fargo scandal occurs, which was technically an “indirect” instance.⁶ As Chair Williams said. “investors already expect – that it is the auditor’s responsibility to proactively be on guard for all noncompliance that may have a material impact on the financial statements.”⁷

A MODEST PROPOSAL TO ADDRESS CHARGES OF “OVERREACH”

Despite the severe need for auditors to do more to combat financial statement errors caused by noncompliance so as to close the performance gap, I acknowledge that there clearly is a difference of opinion between various commentators on how broad the consideration of NOCLAR should be. Virtually since the moment the PCAOB voted to release the proposal on June 6, 2023, critics have suggested that the proposal overreaches. These critics claim the proposal will effectively make public auditors into lawyers who must understand all laws which apply to an issuer, despite the proposal explicitly limiting the universe of relevant potential noncompliance to “laws and regulations with which noncompliance could reasonably have a material effect on the financial statements”⁸. That statement includes not one, but two qualifiers: The noncompliance has to be able to have a material effect, and that effect has to be able to be reasonably foreseeable. That statement in and of itself limits the laws and instances of noncompliance for which auditors must plan, evaluate and/or communicate. The proposing

⁵ John E. McEnroe and Stanley C. Martens, “ Auditors’ and Investors’ Perceptions of the “Expectation Gap””; Accounting Horizons, Vol 15, No 4, December 2001, pp 345-358.

⁶ See, for example, this headline in the Wall Street Journal. (<https://www.wsj.com/articles/wells-fargo-where-was-the-auditor-1478007838>. Accessed August 1, 2023)

⁷ <https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-new-standard-regarding-noncompliance-with-laws-and-regulations> Accessed August 2, 2023.

⁸ PCAOB Release 2023-003, June 6, 2023, page 5

release is quite specific: “These laws and regulations would necessarily be relevant to the company or its operations but would not represent every law or regulation to which the company is subject.”

That said, I agree that auditors are not, and should not, be a secondary substantive compliance and/or legal department⁹. However, I disagree that this proposal would do that, as materiality and reasonableness have long been terms of art for issuers in their MD&A disclosures. Also, I note that some critics seem to pick and choose what areas of expanded auditor activity into non-traditional-financial-statement areas they feel are appropriate. For instance, there is currently a major push among audit firms to assure issuers’ ESG statements (which I applaud), which has not received the same criticism from the same critics. As to the argument that auditors are not lawyers, this proposal does not ask them to be; many audits use “other specialists” (including lawyers) to gain specialty knowledge where necessary. Most importantly, I disagree that the proposal should simply be dismissed based on charges of overreach. That would ignore the costs – both direct and indirect – imposed on issuers, insurance companies, investors and the economy by noncompliance and leave us in the same unacceptable status quo.

Clearly, I would be glad to support the proposal largely as is. However, after reflecting upon instances of noncompliance which have truly harmed investors, I think more clarity can be brought to the types of noncompliance that could cause material indirect impact to the financial statements while mitigating issuer and industry concern that every audit will turn into a compliance exercise covering all the laws to which the issuer is subject. By using bright lines to delimit the indirect areas for which an auditor must plan, evaluate and, if necessary, communicate, I hope a balance can be struck that both limits the amount of new work an auditor must do, and focuses that expanded responsibility to the areas likely to have material impact(s) on the financial statements.

I believe there are two types of noncompliance that auditors should plan to identify, evaluate and, if necessary, communicate. The first is when an issuer systemically allows or encourages noncompliance. The second is when the noncompliance is committed by, encouraged by, or allowed by a senior officer of the issuer and/or the senior management official responsible for a quantitatively material amount of revenue, profit or fixed assets.

1. Systemic noncompliance. It is unfortunate, but also the reality that in a large organization there is a non-zero probability that some employees will cut corners, break rules or not follow laws or other regulations for their own, or the organization’s perceived advantage. Often these are instances of noncompliance that could not “reasonably have a material effect on the financial statements”. For example, a truck driver for a delivery company might well choose to ignore traffic rules for his/her convenience. A branch manager for a bank might choose to open

⁹ An alternate approach to auditor responsibility for noncompliance with laws and other regulations, which the PCAOB has not proposed, would be to focus on reassurance of the issuer’s own compliance and internal audit functions. In effect, that would be the compliance equivalent of the auditor’s responsibilities in integrated audits for assuring that management has adequate internal controls over financial reporting. However, such an approach would require the issuers, the SEC, the PCAOB, the audit industry and perhaps a standard-setter, such as COSO to come together to determine standards for public company compliance departments. At the moment, public company compliance departments are structured, resourced and focused so heterogeneously that such an approach would not be feasible. But it is something to think about for the future.

fictitious accounts for some customers. In and of themselves, such isolated noncompliance is unlikely to have a material effect on the issuer's financial statements.

However, what if the bank had a global policy of opening fictitious accounts and charging customers and that those fictitious accounts were, in fact, a major factor in determining bankers' bonuses in a plan supervised by the head of consumer banking and that it was well-known by the CEO.¹⁰ What if the trucking company directed drivers to ignore traffic rules, agreed to pay the fines, and scheduled deliveries in such a way that a driver could not make the schedule unless he/she broke the speed limits and drove the wrong way on one-way streets. Add a compensation plan that paid bonuses to make more deliveries (despite the impossibility of doing so lawfully) and penalized them for only making as many as they could if they obeyed the laws. Given such a scenario, it would be logical for an auditor to determine if there were pedestrians or other drivers injured or killed, if there are a pending lawsuits, and if there have been financial settlements. And then to evaluate whether the legal reserves are appropriate, including what would happen if legal authorities came to the conclusion that the company was responsible for those deaths and injuries due to its policies.

In both those situations, the systemic nature of the noncompliance increases the reasonable likelihood of the noncompliance having a material indirect effect on the financial statements to the level that a public auditor should determine that issue.

2. Involvement of Senior Management. Investors are concerned, and the potential for financial statement impact is greater, when senior management commits, condones, or turns a blind eye to noncompliance. Auditors should be as well; there is, and has always been, a qualitative aspect to materiality and auditors are responsible for examining "tone at the top" as part of their risk assessment. When a CEO or CFO or other senior management official condones noncompliance, auditors should be asking questions about how large the potential impact (quantitative materiality) could be, and also how much can the auditor trust anything that senior management official says or any reports he/she produces (qualitative materiality). Therefore, the second area of indirect potential impact on the financial statements for which I would suggest public auditors be responsible is if the noncompliance is committed by, encouraged by, or allowed by a) C-suite officials, b) named executive officers, or c) functional heads of operating units or geographic regions that account for more than 5% of the issuer's revenues, profits, expenses or fixed assets.

I thank you for the opportunity to comment.

Sincerely,
Jon Lukomnik

¹⁰ This scenario is, in fact, similar to what happened at Wells Fargo. Similar systemic noncompliance situations include Perdue Pharma and Volkswagen.