Aug 7, 2023

Submitted electronically.

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

Re: PCAOB Rulemaking Docket Matter No. 051

Dear Ms. Brown:

The American Council of Life Insurers[1] appreciates the opportunity to submit comments to the Public Company Accounting Oversight Board's (the "Board") proposed Auditing Standards related to a Company's Noncompliance with Laws and Regulations ("Exposure Draft" or "Proposed Amendments").[2]

Executive Summary

ACLI and its member companies are very supportive of appropriate public disclosures of material legal and compliance challenges that will affect financial statements; however, the Exposure Draft will lead to confusion for readers of audited reports and inappropriately cast auditors in the role of legal advisors, all without materially enhancing the usefulness of audited statements for the public.

- The Exposure Draft is a significant departure from existing auditing standards and would require the auditor to conduct legal and operational analysis of suspected and remote contingencies involving questions of legal compliance. This departure from existing auditing standards includes minimizing considerations of materiality. This will have adverse consequences for both the auditing community and public companies they serve.
- The Exposure Draft raises significant legal considerations for both auditors and the companies that they serve that are not adequately considered in the proposal.
- Finally, while the Exposure Draft acknowledges that compliance costs would be substantial, the Board has not conducted any analysis of the actual costs and has not disclosed any empirical data requiring such dramatic changes. Further, the Exposure Draft

[1] The American Council of Life Insurers (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 95 percent of industry assets in the United States.

[2] PCAOB Release No. 2023-003 June 6, 2023 (https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket-051/pcaob-release-no.-2023-003---noclar.pdf?sfvrsn=fe43e8a_4)

does not disclose any meaningful cost benefit analysis supporting the Proposed Amendments.

As noted below, changes, if any, should be based on empirical data and take the form of additional guidance to improve the existing standards.

The ACLI and its members also broadly support the letter signed by the U.S. Chamber of Commerce and other business community members.

The Proposed Amendments

According to the Exposure Draft, the changes are intended to: "establish and strengthen requirements for (i) identifying [. . .] laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, (ii) assessing and responding to the risks of material misstatement arising from noncompliance with laws and regulations, (iii) identifying whether there is information indicating noncompliance has or may have occurred, and (iv) evaluating and communicating when the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws and regulations [. . .] has or may have occurred."[3]

Specifically, and of greatest interest to ACLI member companies:

- The Proposed Amendments seek to "change the term "illegal acts" [. . .] to "noncompliance with laws and regulations."[4]

- The Proposed Amendments "include [. . .] a requirement for the auditor to obtain an understanding of the regulatory environment and management's processes related to, among other things, identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements."[5]

- The Proposed Amendments would require auditors to make "specific inquiries of management, the audit committee, internal audit personnel, and others regarding noncompliance with laws and regulations."[6]

- Under the Proposed Amendments, "the auditor would be required to evaluate whether it is likely that noncompliance has occurred, [. . . and] to communicate potential noncompliance, and the subsequent results of the auditor's evaluation of such potential noncompliance, to management and the audit committee."[7]

The Exposure Draft will cast auditors in the additional roles as legal advisors and operational and management professionals for public companies. As skilled as auditors are, this reflects a significant departure from existing auditing standards[8] that will have adverse consequences for both the auditing community and public companies. As we describe below, our fundamental concern is that the Exposure Draft would place a burden on auditors to make legal determinations beyond their expertise and traditionally understood function, and beyond what is needed and

[3] PCAOB Release No 2023-003 at 5.
[4] PCAOB Release at 6.
[5] PCAOB Release at 5 - 6.
[6] PCAOB Release at 5 - 6.
[7] PCAOB Release at 7.
[8] See, e.g. AS 2110.09.

appropriate for public financial statements. A better approach is to provide additional clarity for auditors built on the current guidance.

Existing Standards - AS 2405

As noted, ACLI and its member Companies support the Board's goal of improving the transparency, timeliness and usefulness of financial information that is disclosed to investors and other users of financial statements. We understand that some commentators have been concerned that, under AS 2405, Illegal Acts by Clients ("Current AS 2405")[9], some auditors might be confused with respect to the distinction between "direct" and "indirect" impacts on financial statements. We are also aware of efforts towards international convergence of accounting standards and the general trend in financial accounting to require more robust disclosure in financial statements or disclosed in notes to them. We are not aware, however, of empirical data that suggests that the current standards and the reporting practices that have developed under those standards are inadequate in addressing actions (or non-actions) that may materially impact financial statements with regard to legal compliance. The Exposure Draft neither includes any such empirical evidence, nor seeks to obtain it.

Current AS 2405 properly recognizes both the interests of stakeholders in robust disclosure, and the interest of a reporting entity and its shareholders in appropriately protecting the entity's legal position and maintaining the protection for privileged or confidential information about litigation and regulatory and enforcement matters.[10] As proposed in the Exposure Draft, AS 2405, A Company's Noncompliance with Laws and Regulations ("Proposed AS 2405"), particularly as applied to the legal and regulatory environment and contingencies arising from potential operational concerns, raises a number of problems and will likely have unintended, but seriously adverse consequences for reporting entities. The Exposure Draft does not meaningfully consider the consequences, unintended or intended, in any meaningful way.

The ACLI and its members are particularly concerned with the proposed requirements that auditors assess the legal landscape of a company and make (legal) determinations as to whether or not likely violations of laws and regulations have occurred. Proposed AS2405 goes far beyond the requirements of Current AS 2405 and Section 10A of the Securities Exchange Act of 1934. Importantly, the proposed procedures would appear to require the auditor to undertake significant steps without regard to materiality and even in cases where the noncompliance itself is still in question.[11] Moreover, as contemplated by the Exposure Draft, an auditor would need to consider all laws and regulations – 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. This type of sweeping broadening of an auditor's ambit is beyond the range of any existing legislative authority.

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[9] AS 2505: Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments | PCAOB (pcaobus.org)

[10] The Current AS 2405 mirrors in substantial part Section 10A of the Securities Exchange Act of 1934, which requires the auditor to examine "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," 15 U.S.C. § 78j-1(a)(1) (emphasis added).

[11] The Exposure Draft must consider materiality. 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" *TSC Industries v. Northway, Inc.,* 426 U.S. 438, 439 (1976) as cited in SEC *Staff Accounting Bulletin No. 99* (August 12, 1999) (emphasis added).

It appears to ACLI that there is no basis or guidance as to how a reasonable auditor is expected to make such estimates and predictions. The end result will likely be greater, not less, confusion for auditors.

Specific Legal Considerations

The Exposure Draft fails to take into account certain basic aspects of the adversarial system of justice in the United States and threatens to put reporting entities at a serious disadvantage in that process. This is one of those situations where the potential harm to reporting entities and their shareholders from the required disclosures outweighs the potential benefits to investors and other users of financial reports. Moreover, much of the newly required information would be either highly speculative – leading to misleading disclosures – or prejudicial without adequate protections. Critically, the Exposure Draft uses terms such as "may," "might," and "likely" throughout. These terms are not defined in the Exposure Draft and are not, in any way, reconciled with the Supreme Court definition of materiality – and its relevant concepts of "substantial likelihood" and "would."[12]

For reasons that are discussed below, the Exposure Draft's proposed solutions to the articulated, yet empirically unclear problems, will result in disclosures that would expose reporting entities and their shareholders (and possibly the auditors themselves) to significant additional risk without commensurate utility for investors. There are many reasons for our concerns:

1. The U.S. Legal System has Characteristics and a Role that is Unique
   The Exposure Draft does not adequately take into account the unique nature of the United States legal system. The United States employs an adversarial system of justice and has a uniquely active litigation and regulatory environment and plaintiffs' bar that proactively looks for any indicia that predicts an impact on the finances and/or share price of a public company. In this environment, claims are often filed making demands that far exceed the amount of real harm suffered by plaintiffs and the amounts, if any, that will ultimately be paid in settlement or judgment. Litigation in the United States is more prolific than in most of the rest of the developed world, with many large, complex cases, class actions, derivative suits, and claims for punitive and treble damages. This is an important counter to the impetus to harmonize certain auditing processes in the United States with the international community. Indeed, in some jurisdictions it would be virtually impossible to bring actions based on the types of information and findings contemplated in the Exposure Draft.

2. Other National Legal Systems' Differences Would Place U.S. Companies at a Disadvantage
   The attributes of the United States litigation environment should be compared to the judicial systems in other countries—in Europe and in Asia, for example — with well-developed sophisticated economies. For example, it is noteworthy that in Europe and Asia, unlike the United States, commercial cases are rarely decided by juries. Given the inherent unpredictability of juries, the risk of attempting to estimate litigation outcomes in jury cases is greater than in cases tried to a court or administrative tribunal.

3. Implementation of Exposure Draft Could Expose Companies to Claims of Legal Privilege
   The United States has far more liberal discovery rules than any other country that will permit plaintiffs to inquire into the facts underlying the disclosures and, likely, lead to claims in many cases that applicable privileges have been waived by the reporting entity. To the extent that the proposed new standard leads to findings that companies have waived applicable

[12] *TSC Industries v. Northway, Inc.,* 426 U.S. 438, 439 (1976).

privileges by disclosing confidential communications with counsel in their quantitative and qualitative assessments of litigation (see below), the proposed new disclosure standards threaten to subject companies and their counsel to broad-ranging discovery by adversaries regarding the disclosures.

4. Exposure Draft Would Require Auditors to Make Legal Determinations

Only licensed attorneys are permitted to analyze laws and make recommendations based on such analyses. The Exposure Draft would compel auditors to obtain an understanding of applicable operational laws & regulations, and then determine whether or not it's likely that any of these laws and regulations have been violated.

The Exposure Draft expressly acknowledges the extent of the legal work needed to be done by auditors:

> "Auditors would likely need to expend considerable additional audit effort to identify relevant laws and regulations under the proposed standard. The effort required to identify the relevant laws and regulations would depend on many factors, including the size and complexity of the company, the existence of multinational operations, the nature of the company's industry, etc. as each of these factors could affect the number of laws and regulations and the extent to which noncompliance with them could reasonably have a material effect on the financial statements. The elimination of the distinction between noncompliance that has direct versus indirect effect on the financial statements would likely further expand the number of laws and regulations that an auditor must consider as part of identifying relevant laws and regulations."[13]

The mere breadth of such an undertaking in an industry such as life insurance would be daunting to say the least. Life insurance companies have a complex network of state, national and international legal requirements and oversight that has been created and refined for over 175 years. There are literally thousands of laws and regulations that are applicable to the business of life insurance. An auditor is not equipped to canvass these laws and regulations, much less determine the likelihood of violation(s). Moreover, every life insurance company is subject to comprehensive financial and marketplace oversight by the state insurance department in which the company is domiciled. This oversight includes examinations and reporting that encompasses compliance with applicable laws and regulations.

The Proposed Amendments would inappropriately place auditors in the role of quasi-regulator as well as that of quasi-counsel. This blurring of roles and responsibilities will likely be both redundant and ultimately harmful to consumers, public companies, investors and auditors.

Cost Considerations

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."[14] Yet the Exposure Draft does not attempt to quantify "substantial". The required economic analysis is completely lacking in this area. The Board makes no attempt to quantify the expected costs of the

[13] PCAOB Release at 79 (emphasis added).
[14] PCAOB Release at 76 (emphasis added).

Proposed Amendments or even provide baseline data – such as the current level of audit fees. This type of analysis would be the bare minimum needed to be considered by the Board in considering such sweeping changes.

And these changes would have an unduly burdensome impact on ACLI members and their auditors. As noted above, requiring auditors to canvass the legal landscape of a business, particularly a complex one like life insurance, will be an arduous task. This significant expansion of responsibility will likely require auditors to rely increasingly on legal specialists, and, in the case of life insurance companies regulated by a robust state system, state regulatory specialists. The Board has not made any inquiry into or any provision for the complexities of the markets in which companies operate. This type of change cannot, practically, be considered a "one size fits all".

Specific Auditing Considerations

As pointed out by Board Member Christina Ho in her dissenting statement, this proposal seems to change the auditor's role from one of providing reasonable assurance into one of performing a management function.[15] Current securities laws and regulations do not require a public company's management to identify all laws and regulations to which the public company is subject. This proposal would require auditors to do so, which undermines the framework whereby management prepares and discloses financial information and auditors provide an independent audit report on that financial information. This proposal would require auditors to understand aspects of the company beyond what current securities laws and regulations require of management and to become involved with a company's operational controls.

More specifically the Proposal makes a significant change to the existing standards against which auditors have worked. The existing 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 impact (e.g., laws related to securities trading, employment practices and anti-trust). These indirect impacts are normally identified because the company is considering (and disclosing) a contingent liability because of allegations or determinations of illegality.[16] Broadly speaking, laws and regulations with indirect effects generally relate more to an entity's operations and not financial statements. The Exposure Draft would require an auditor to identify this vast swath of laws and regulations that would not impact internal control over financial reporting.[17]

Recommendations for Clarifying Auditor Duties Involving Disclosure of Legal Risks

The focus of any amendments to the auditing standards should be exclusively on making the standards as simple as possible for auditors to determine which legal risks (if any) should be contained in reports. This can best be accomplished by providing examples of the categories of

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[15] Statement on Proposed Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations | PCAOB (pcaobus.org).

[16] See, e.g. AS 2405.05 and AS 2405.06

[17] We note that the Exposure Draft includes a significant expansion into the auditor's understanding of management's risk management practices, which are, generally, operational in nature. Specifically, the Exposure Draft requires an auditor to understand how management will:

- Identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements;
- Prevent, identify, investigate, evaluate, communicate, and remediate instance of noncompliance; and
- Receive and respond to tips and complaints from internal and external parties regarding noncompliance.

PCAOB Release at 21.

risks that should be disclosed, as well as examples of those categories that need not be disclosed. The Proposed Amendments themselves refer to the "unconditional nature" of the revisions (pg. 82), and we concur that this is the case. Overly complex, vague standards are not going to be useful to either the audit or investing communities.

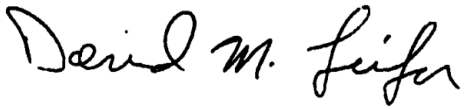
While ACLI and its member companies are very supportive of appropriate public disclosures of material legal challenges that will likely affect financial statements, we believe the exposure draft will lead to confusion for readers of audited reports, inappropriately cast auditors in the role of legal advisors, all without materially enhancing the usefulness of audited statements for the public.

We stand ready to answer any questions and thank the Board for the opportunity to present these comments for your consideration.

Very truly yours,

Patrick Reeder
VP & Deputy General Counsel

Mike Monahan
Sr. Director, Accounting Policy



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