American Federation of Labor and Congress of Industrial Organizations

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By email to comments@pcaobus.org

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

Re: PCAOB Rulemaking Docket Matter No. 051, Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments

Dear Board Members:

On behalf of the American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO"), I am writing to provide comments on the Public Company Accounting Oversight Board (the "PCAOB") proposed Auditing Standards related to a Company's Noncompliance with Laws and Regulations (PCAOB Release No. 2023-003). The AFL-CIO is a voluntary federation of 60 national and international labor unions that represent 12.5 million working people. Union members participate in the capital markets as individual investors and as participants in pension and employee benefit plans. We are writing to strongly support the PCAOB's proposal and to recommend certain improvements in the final standard.

The proposed standard will go a long way to closing the gap between what investors expect auditors to do regarding a company's noncompliance with laws and regulations and what the PCAOB's existing auditing standards actually require. This investor expectations gap was dramatically illustrated at the 2017 annual meeting of Wells Fargo when shareholders demanded to know why the company's auditor KPMG had not discovered the company's fraudulently created accounts. Wells Fargo's CEO replied that the auditor "did their job properly" because the sham accounts had not affected the company's financial controls.[1] The PCAOB's proposed standard will better align the obligations of auditors with the expectations of investors for detecting violations of laws and regulations.

As the PCAOB's release notes, the current AS 2405 *Illegal Acts by Clients* standard is one of the legacy standards adopted by the PCAOB in 2003

[1] Johnathan Berr, "Wells Fargo Meeting Erupts, As Investors Fume Over Scandal," CBS News, April 25, 2017.

that is based on a standard that was first issued by the AICPA's Auditing Standards Board in 1988. As a result, it is seriously out of date and does not reflect investor expectations for auditors to identify and respond to potential noncompliance with laws and regulations. The proposed standard setting approach taken by the PCAOB is a strong step forward in clarifying the obligation of auditors with respect to the detection of fraud and noncompliance with laws and regulations. All too often when a fraud is exposed, it rarely comes to light from the auditors. This should change and the proposed standard moves in that direction.

Ideally, the PCAOB's auditing standards should require auditors to have uncomfortable conversations with management, including the audit committee, about evidence of noncompliance and, at least in some cases, the potential effects on the financial statements. Because the proposed standard is an internal reporting obligation that is designed to put directors on notice of legal and regulatory noncompliance, the PCAOB should seek to maximize the amount of information communicated to directors. Directors will often be in the best position to assess the impact of evidence of noncompliance on the company and take appropriate action, particularly when related to non-financial matters.

Much of the approach taken in the proposed standard provides what should already be the norm with respect to audits. The proposal, for example, would require firms, in considering laws and regulations that could have a material effect on financial statements, to explicitly consider those that could have an indirect effect. Presumably auditors already do this when conducting the required risk assessment for material misstatements in the financial statements. Indeed, it is hard to imagine a firm providing reasonable assurance that financial statements are free from material misstatements without taking these considerations into account.

We recommend, however, a number of improvements to the final auditing standard. First, we believe that the standard should explicitly provide that auditors with more than 100 public company clients be required to assess (rather than simply understand) the system of internal compliance to determine whether the processes are sufficient to identify, evaluate and investigate possible instances of noncompliance with laws and regulations. The assessment – including any weaknesses in the system – should be a required communication to the audit committee.

Second, the requirement that auditors consider whether possible noncompliance is "likely" should be eliminated from the standard. The proposed approach essentially allows firms that uncover possible instances of noncompliance to avoid considering the impact on financial statements where they conclude that the noncompliance was not "likely." Instead, firms should be required to assess the impact for all instances of noncompliance and possible noncompliance.

Third, the proposed standard should reduce or eliminate some of the exceptions to mandatory communications with the audit committee. The standard is fundamentally designed to put the audit committee on notice of noncompliance uncovered during the audit. Exceptions to this obligation to communicate should, therefore, be narrowly granted. We therefore recommend the elimination or narrowing of the exceptions for noncompliance deemed "clearly inconsequential" or already reported to the committee in writing.

I. Identification

Under the proposed standard, auditors will need to identify those laws and regulations "with which noncompliance could reasonably have a material effect on the financial statements." This does not, as some have suggested, require auditors to identify all the laws and regulations applicable to the public company. The vast majority of laws and regulations will have no reasonable capacity to materially affect the financial statements. Moreover, boards of directors regularly make similar distinctions in the discharge of their duties. Under the *Caremark* legal standard, directors are not obligated to monitor every possible legal risk but are obligated to monitor compliance matters that are "intrinsically critical to the company's business."[2]

We also strongly support the requirement that auditors should consider both the direct and indirect effects of legal and regulatory noncompliance. From an investor perspective, we have assumed that this was already required under the existing standards. Auditors are expected to engage in a risk assessment to uncover possible material misstatements in the financial statements.[3] Noncompliance that can affect the financial statements is relevant to assessing this risk whether it does so directly, say through an understatement of pension obligations, or indirectly, for example through bribes paid to a foreign government official.[4] We are frankly surprised and disturbed that some do not, apparently, view this as necessary and wonder how firms can provide reasonable assurance when they omit consideration of noncompliance that could reasonably have a material effect on the financial statements.

We further strongly support the requirement that, in identifying and considering relevant laws and regulations, auditors should be required to consult a wider array of public sources[5] including social media accounts for officers making statements on behalf of the company.[6] For example, the SEC has treated social media accounts in at least some cases as statements by the

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[2] *Marchand v. Barnhill*, 212 A. 3d 805 (Del 2019).
[3] *See* AS 2110, Identifying and Assessing Risks of Material Misstatement.
[4] PCAOB Release No. 2023-003 ("Other illegal acts, such as violations of occupational safety, health, and environmental laws, may have an indirect effect on the financial statements. The laws involved often relate more to a company's operations than its financial reporting and by themselves would ordinarily not result in financial reporting obligations. These laws ordinarily only result in recording obligations when the company does not comply and a penalty, fine, or contingency needs to be recorded.").
[5] PCAOB Release No. 2023-003 ("The volume of information about the company from sources external to the company, such as media reporting and analyst reports, has also become more prevalent. The proposal enhances the risk assessment requirements by expanding the sources of information the auditor looks to when assessing risks of material misstatement in the financial statements, which should lead to more informed and complete audit responses.").
[6] PCAOB Release No. 2023-003 ("These sources include the company's website, the company's or its executive officers' social media accounts, media reporting, and analyst reports.").

company.[7] We also note that the definition of public sources appropriately includes corporate sustainability reports that many investors rely on to inform their investment decisions.[8]

Examination of this information may demonstrate inconsistencies between statements made to the public and assumptions used in the financial statements.[9] The review may also suggest possible inconsistencies not directly related to the financial statements. Public disclosure could, for example, be inconsistent with assumptions used in determining targets for greenhouse gas emissions or in the calculation of key performance indicators. They could suggest possible violations of the federal securities laws, including the antifraud provisions. Such instances would, therefore constitute instances of possible noncompliance that should be communicated to the audit committee of the board of directors.

II. Assessment

Once having identified the relevant laws and regulations, the proposed auditing standard would require auditors to assess the risk that noncompliance could result in material misstatements.[10] The risk assessment would require firms to obtain an understanding of management's processes related to "preventing, identifying, investigating, evaluating, communicating, and remediating noncompliance with such laws and regulations" and the system for "receiving and responding to tips and complaints from internal and external parties regarding noncompliance with laws and regulations."

In obtaining this "understanding," firms may uncover significant deficiencies in the company's system of compliance. Where a firm determines that the system of internal compliance is not adequate to prevent, identify, investigate or evaluate instances on non-compliance in areas that could have a material effect on the financial statements, the proposal should provide that there is a presumption that noncompliance has or may have occurred and that the matters, including the deficiencies, be communicated to the audit committee.

The proposal, however, should go further, at least for firms that audit more than 100 public companies. These firms should do more than "understand" but should be required to assess the system's capacity to identify, evaluate and investigate noncompliance and identify any

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[7] *See e.g.,* Securities and Exchange Commission, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings, Exchange Act Release No. 69279 (April 2, 2013).
[8] PCAOB Release No. 2023-003 ("Publicly available information may provide the auditor with insight into potential changes to the company's business or operations. For example, a company's sustainability reporting may indicate that the company plans to reduce greenhouse gas emissions to a certain level within a defined period of time.").
[9] PCAOB Release No. 2023-003 ("Reading such information may bring to the auditor's attention statements made by the company and its executive officers, which may be contradictory to other information obtained by the auditor or within the financial statements and may indicate potential risks of material misstatement in the financial statements. Information from these sources may also assist the auditor in identifying and assessing risks of material misstatement related to accounts or disclosures in the financial statements or omitted, incomplete, or inaccurate disclosures.").
[10] PCAOB Release No. 2023-003 ("Upon identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, the proposed amendments would require the auditor to perform risk assessment procedures to assess the risk of material misstatement of the financial statements due to those laws and regulations.").

significant weaknesses. The proposal already hints at how this might be accomplished by noting that in some instances, auditors may need to "test relevant controls,"[11] consider work done by a company's specialist, or review reports from relevant regulators. An assessment would require some or all of these steps. The results of the assessment, including any weaknesses in the system of compliance should be reported to the audit committee.

III. Evaluation

The auditor's assessment or understanding of the control environment, along with consideration of public sources and other procedures undertaken as part of the audit, may identify instances where noncompliance has or may have occurred. Where auditors learn that noncompliance occurred or may have occurred, the proposed standard would require an understanding of the nature and circumstances of the noncompliance.[12]

The proposed standard lists a number of procedures that may be used to achieve this understanding. We support this approach but believe that the standard should include more guidance on the procedures that must (rather than may) be implemented. The proposal should add a note to that effect. We suggest the following:

> Note: In assessing the nature and circumstances of noncompliance or possible noncompliance, this should include procedures designed to provide an understanding as to whether, among other things, the noncompliance was or was not isolated, involved the participation of management, including through an inadequate tone at the top, or resulted from intentional behavior.

With respect to noncompliance that "may have occurred," the standard would not require that auditors assess the possible effects on the financial statements. Instead, the proposal contemplates that auditors will assess whether possible violations are "likely" and only then have an obligation to assess the impact on the financial statements.

We think this limitation unnecessary and would effectively reduce the information provided to audit committees. "Likely" is a high standard. The Merriam-Webster's Dictionary defines "likely" as "having a high probability of occurring or being true: very probable." Thus, under the proposed standard an auditor may find possible violations that may have occurred and yet determine that the illegal acts are not highly probable to have occurred. In those

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[11] PCAOB Release No. 2023-003 ("For example, if an auditor identified the FCPA as a law that could reasonably have a material effect on the financial statements because the company's operations are in a jurisdiction where bribery may be more common, or the company or its competitors have a history of FCPA violations, the auditor in planning and performing procedures would understand management's processes around FCPA compliance, test relevant controls that were put in place to maintain compliance with the FCPA, or perform cash disbursement testing designed to identify potential bribes.").

[12] PCAOB Release No. 2023-003, Proposed Amendments to AS 2405.07 ("When the auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred (regardless of whether the effect of such noncompliance is perceived to be material to the financial statements), the auditor must (1) obtain an understanding of the nature and circumstances of any such noncompliance; and (2) determine whether it is likely that any such noncompliance occurred.").

circumstances, there will be no obligation to assess the effects of the possible violations on the financial statements and report the effects to the audit committee.[13]

We believe that auditors should have an obligation to consider (and report to audit committees) the effects of all instances of actual and possible noncompliance uncovered during the audit. This approach would be consistent with Section 10A of the Exchange Act that requires auditors to consider the effects of illegal acts that are "likely" on the financial statements. Requiring firms to consider the effects on the financial statements of both actual and possible instances of noncompliance will encompass this Section 10A requirement. As such, we recommend amendments to AS 2405.08, AS 2405.09 and AS 2405.14 to provide the following:

> .08 Obtaining an understanding about the nature and circumstances of any such noncompliance with laws and regulations **that has occurred or may have occurred** ~~and determining whether it is likely that any such noncompliance has occurred~~ may include the following procedures:
>
> […]
>
> .09 When the auditor determines, based on information obtained, that **noncompliance with laws and regulations has occurred or may have occurred,** ~~it is likely that noncompliance with laws or regulations has occurred,~~ the auditor must:
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> […]
>
> .14 After the auditor has completed the evaluation of the information indicating that noncompliance has or may have occurred, the auditor should communicate to management and, unless the matter is clearly inconsequential, also to the audit committee the results of the auditor's evaluation, including~~:~~
>
> ~~a. Which of the matters, if any, communicated pursuant to paragraphs .12–.13 are likely noncompliance; and~~
>
> ~~b~~. ~~For instances of likely noncompliance,~~ whether there is **or may be** a material effect on the financial statements.

IV. Communication

The proposed standard provides that auditors must communicate to the appropriate level of management and the audit committee any instances of noncompliance that occurred or may have occurred. With respect to the audit committee, however, there are two exceptions. The information need not be communicated to the audit committee if "clearly inconsequential" or

[13] PCAOB Release No. 2023-003, Proposed Amendments to AS 2405.09 ("When the auditor determines, based on information obtained, that it is likely that noncompliance with laws or regulations has occurred, the auditor must:").

already communicated by management in writing.[14] Both exceptions were presumably designed to avoid the communication of repetitive or unimportant information.

Nonetheless, boards of directors and managers are often in a better position than auditors to assess the impact of seemingly isolated or otherwise unimportant information. They may have additional sources of information that can provide additional context and additional resources to follow-up on any broader implications. Exceptions to the communication obligations of auditors should be rare and narrow. We therefore recommend two changes.

First, the exception of information conveyed in writing by management is too broad. Audit committees often receive written information about possible noncompliance. For listed companies, the Sarbanes-Oxley Act requires that audit committees have in place a system for reporting anonymous tips from employees concerning financial or auditing matters.[15] Similarly, Delaware case law effectively requires that boards of directors have a system for obtaining whistleblower complaints.[16] These reports may not get the same degree of consideration or attention that would have been the case had they come from the auditor.

We therefore strongly encourage the PCAOB to eliminate the exception for information reported from other sources in writing to the board of directors unless those sources identify that the matter has been evaluated by the auditor, effectively placing the board on notice that this has occurred. We also would eliminate the ability of auditors and management to negotiate away disclosure obligations.[17]

The "clearly inconsequential" exception likewise raises concerns. The exception applies to the board of directors but not management. We are troubled by this distinction. With the information already going to management, there is no additional cost in providing the same information to the audit committee. Moreover, by providing the information to management, there is no guarantee that it will be given to the board, even if deemed "necessary."[18]

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[14] PCAOB Release No. 2023-003 ("Note: As part of its communications to the audit committee, management might communicate some or all of the information regarding the noncompliance required under paragraphs .12 and .13. The auditor does not need to repeat information about such noncompliance that management previously communicated in writing to the audit committee or if the auditor participated in management's discussion with the audit committee about the noncompliance. The auditor must communicate any omitted, incomplete, or inadequately described information regarding the noncompliance to the audit committee.").

[15] 17 CFR § 240.10a-3 — Listing standards relating to audit committees.

[16] *See In re Boeing*, No. 2019-0907-MTZ (Del. Ch. Sept. 7, 2021).

[17] See PCAOB Release No. 2023-003 ("The auditor is not required to communicate to the audit committee matters that are clearly inconsequential; moreover, the auditor may reach an agreement in advance with the committee on the nature of such matters to be communicated.").

[18] *See* Jennifer O'Hare, *Private Ordering and Improving Information Flow to the Board of Directors: The Duty to Inform Bylaw*, 53 U. Rich. L. Rev. 557, 592 (2019) (noting that "the question remains open" whether "officers have a broad and ongoing duty to inform the board of all necessary information.").

The "clearly inconsequential" exception should be eliminated in its entirety. Alternatively, we recommend the inclusion of a definition.[19] The definition should take into account that seemingly unimportant instances of noncompliance may ultimately prove quite important. Small or isolated matters if unaddressed may eventually turn out to be significant. Moreover, the audit committees may be aware of additional information (or have the resources to obtain additional information) that enhances or clarifies the importance of the noncompliance identified by the firm. As a result, we propose the following definition:

> "Clearly inconsequential" shall include only those instances of noncompliance or possible noncompliance that no auditor would view as having any possibility, in the current or in subsequent fiscal years, of resulting, in or contributing to, a direct or indirect material effect on the financial statements. Any matter that requires consideration as to whether or not an experienced auditor having no previous connection to the engagement would view the matter as clearly inconsequential should also not be viewed as clearly inconsequential.

V. Conclusion

We greatly appreciate the hard work that went into the development of the proposed auditing standard and we commend the PCAOB for updating the legacy standards that were adopted on an interim basis by the PCAOB in 2003. This proposal very much demonstrates how auditing standards can evolve in a manner that will improve the quality of, and improve investor trust in, financial statements of public companies and broker-dealers. If I can be of further assistance, please contact me at (202) 637-5152 or brees@aflcio.org.

Sincerely,

Brandon J. Rees
Deputy Director, Corporations and Capital Markets

[19] PCAOB Release No. 2023-003 ("We believe that a matter deemed clearly inconsequential would be significantly below the threshold of materiality when considering both qualitative and quantitative factors. Any matter that requires consideration as to whether or not an experienced auditor having no previous connection to the engagement would view the matter as clearly inconsequential should also not be viewed as clearly inconsequential. The proposed standard includes a note with a presumption that any matters involving senior management are not clearly inconsequential.").