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Via email to comments@pcaobus.org

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Office of the Secretary
Public Company Oversight Board
1666 K Street, NW
Washington D.C. 20006-2803

Request for Comments: Amendment to PCAOB Auditing Standard AS 2405 "A Company's Noncompliance with Laws and Regulations" (the "Proposal")

Dear Secretary:

The Bottom Line

For the following reasons, the Board should revisit, revise and re-propose the Amendment to AS 2405.

PCAOB 2022 Inspection Observations

Rather than focusing on a standard for the noncompliance with laws and regulations (NOCLAR), the PCAOB should devote more of its resources towards achieving its goal of no deficient audits – NODA.

The Fortune Magazine headline reads: 22 years after the $63 billion Enron collapse, a key audit review board finds the industry in a 'completely unacceptable' state.[1]

This headline is followed-up with a "whopping third of all audits conducted by U.S. accounting firms in 2022, including the Big Four, contained errors, according to … the PCAOB. … And make no mistake, as audit reviews go, the 2023 version from the PCAOB was scathing."

[1] Fortune Magazine, Rachel Shin, July 26, 2023.

The PCAOB's July 2023 Staff Report[2] highlights a year-over-year increase in audit deficiencies by audit firms inspected in 2022. The report reveals that overall, about "40% of the audits reviewed will have one or more deficiencies that will be included in Part I.A of the individual audit firm's [PCAOB's] inspection report, up from 34% in 2021 and 29% in 2020."[3]

Part I.A discusses deficiencies that are serious and significant enough for the PCAOB staff to believe the audit firm, when they issued the audit report, "had not obtained sufficient appropriate audit evidence to support their opinion on the financial statements.[5]"

In the related news release,[4] PCAOB Chair Erica Y. Williams said (among other things):

- These deficiencies are up for nearly every category of the 157 audit firms the PCAOB inspected in 2022, including global network firms both in the U.S. and internationally.
- Let me be clear: a 40% Part I.A deficiency rate is completely unacceptable.
- We … will continue demanding firms do better and deliver the high-quality audits investors deserve.
- We have demonstrated that we will not hesitate to bring enforcement cases against auditors where appropriate.
- We are also asking audit committees to hold audit firms accountable on behalf of investors.

Further, the SPOTLIGHT report states that "we [the PCAOB staff] observed an increase in lack of compliance by firm personnel, including partners and/or senior management, with their firm's own policies and procedures. This may raise concerns about firm leadership's commitment to audit quality."

This report sets out a sizable number of other deficiencies and more negative information about the current state of auditing by public accounting firms. The report clearly demonstrates that overall, auditors of financial statements[5] are struggling with the fundamental "blocking and tackling" skills required to effectively audit public companies.

Nonetheless, this Amendment to AS 2405 aims to add a new task for auditors, the identification of all laws and regulations the client must adhere to and then identify those instances where the client failed or probably (likely) failed to comply with.

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[2] This 25-page report is titled SPOTLIGHT: Staff Update and Preview of 2022 Inspection Observations, July 2023.

[3] Deficiencies were found by the PCAOB's staff in various audit areas, including: internal controls over financial reporting, revenue and related accounts, accounting estimates, business combinations, inventory, long-lived assets, and cryptocurrency transactions. Noncompliance with PCAOB standards and rules also increased, with deficiencies related to critical audit matters, audit committee communications, and audit documentation.

[4] Chair Williams Statement on the Rise in Audit Deficiency Rates, Washington, DC, July 25, 2023.

[5] and/or internal control over financial reporting.

The Proposal asks auditors, who have no education or training in "laws and regulations," to perform procedures that go well beyond their current knowledge base and experience. These new tasks and procedures far exceed the auditor's current skills, competence, and expertise.

Critical Thinking of the Two Dissenting Board Members

I agree with the statements of Christina Ho and Duane M. DesParte, the two PCAOB Board Members who dissented from issuance of the Proposal. Since the dissenting comments are concise and persuasive and match mine, I will quote some of their compelling arguments in opposition to this Proposal.

Christina Ho[6]

In stating her dissent, Ho correctly points out that the Proposal—

- Contains a breathtaking expansion of the auditors' responsibilities.
- Is not fully transparent about the significant additional responsibilities it would impose on all public company auditors by eliminating the distinction between noncompliance that has a direct versus indirect effect, on a public company's financial statements.
- Requires the auditors to plan and perform procedures to "identify the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements."[7] But to properly perform this procedure the auditor must first identify all the laws and regulations applicable to the public company. Ho then cites the following contradictory sentence in the introduction to the Proposal:

  > 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.[8]

  I note that this conflicting statement is not in the proposed Amendment.

Continuing, Ho –

- Draws our attention to the fact that the Proposals requirements are really the responsibility of management. The securities laws and their regulations do not require management to identify all laws and regulations that the public company is subject to. This proposal aims to fill that void by requiring auditors to do so. She states the Proposal changes the auditor's role from obtaining "reasonable assurance" to performing a management function. It is management who prepares and discloses financial information, while the auditors provide an independent opinion on those

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[6] Christina Ho, Statement on the Proposed Amendments, June 6, 2023.

[7] AS 2405.03(a) and .05(a).

[8] This language (on page 22 and repeated on page 29) appears in the introductory "discussion of the proposal."

disclosures. The Proposal blurs the line between the auditor's role and management's responsibilities.

- Directs us to the economic and cost analysis which explains that "auditors would likely need to expend considerable additional audit effort to identify relevant laws and regulations under the proposed standard" and that "the costs associated with the proposed amendments . . . may be substantial."[9] Moreover the new requirements will significantly expand auditors' need for expertise from lawyers, legal experts, and possibly other specialists, resulting in a substantial increase in audit fees.
- Points out the that the "proposal takes a one-size-fits-all approach and does not consider differences between large auditing firms on the one hand, and mid-sized and smaller firms on the other hand.
- Is "concerned that the proposal would create additional barriers to entry. Investors and the auditing profession can ill afford these barriers, given that the audit market for large multinational public companies is limited to roughly a handful of firms capable of performing such engagements. This significant expansion of auditor responsibilities could therefore further reduce competition and exacerbate the power concentration in the audit marketplace."
- Confirms what we know to be true: "Auditors are CPAs, not legal experts (emphasis added)."

Duane M. DesParte[10]

I agree with Duane DesParte's comprehensive concerns which are –

- The Proposal is not clear that the concept of reasonable assurance applies to the (a) auditor's identification of noncompliance and (b) information indicating noncompliance. DesParte states that "Reasonable assurance, rather than absolute assurance, should apply."
- The Proposal "may be establishing a requirement beyond existing requirements in AS 2710[11] … for auditors to validate whether management has appropriately disclosed information on noncompliance outside the audited financial statements" (footnote omitted).
- Whether it is useful (or a distraction) to the Audit Committee "for the auditor to communicate information indicating potential noncompliance before the auditor's evaluation of whether the noncompliance has likely occurred, or of any financial statement impacts (vs. only reporting matters deemed likely to have occurred and/or to have material financial statement implications)."

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[9] See page 79 of the introductory discussion.

[10] Duane DesParte, Statement on the Proposed Amendments, June 6, 2023.

[11] Titled Other Information in Documents Containing Audited Financial Statements.

- Whether the PCAOB is adding to the "expectations gap by imposing responsibilities on auditors not aligned with their core competencies or the fundamental purpose of a financial statement audit."
- That paragraph .05 of the Proposal "… is a significant scope expansion; and to meet this requirement, auditors would be required to embed compliance attestation procedures into the financial statement audit. This is well beyond both the scope of the financial statement audit and the auditor's core competency; and will trigger the need - at great cost - to significantly increase the use of lawyers and others as specialists on many, if not all PCAOB audit engagements on a recurring basis. The scope of the expanded auditor's procedures cannot be underestimated."
- As to lawyers, the Proposal will expand "the scope of the audit to incorporate extensive new procedures and will require legal acumen and expertise well beyond the auditor's core competency. Also, "lawyers will be required across the wide array of legal disciplines and specializations to assist the auditor in identifying the population of relevant laws and regulations, assess the 'could reasonably' scoping filter, design and perform compliance attestation procedures to identify information that may indicate potential noncompliance and evaluate whether such noncompliance has or has likely occurred."
- He points out that the "Staff's economic analysis highlights the significant harm fraud and other noncompliance has inflicted on companies, investors, employees, and others across society. The analysis also concludes today's proposal is likely to significantly increase audit effort and costs across virtually all firms and audits (and thus on preparers and investors). What is less clear is whether certain of the increased requirements are appropriate for the auditor in the context of the auditor's expertise and the objectives of a financial statement audit."

Board Members Backing the Proposal

Kara M. Stein

Kara M. Stein, a Board Member supporting the Proposal[12], argues that this proposal is necessary, some 35 years after the interim standard was last revised in 1988. Stein contends that the interim standard "does not take fully into account a series of unfortunate events" and fails to take into consideration the passage of the Sarbanes-Oxley Act of 2002 ("SOX"). (Emphasis added.) She believes that the Proposal is central to the Board's mission, and it covers the ground that Congress intended to address when enacting SOX.

If the Proposal had been an auditing standard for the last 35 years, I believe it would not have served as a deterrent to the noncompliance of laws and regulations; rather the same,

[12] In remarks titled A Return to Roots: The Auditor's Role in Uncovering and Reporting Illegal Acts, at the June 5, 2023, PCAOB Open Board Meeting.

comparable, Black Swan,[13] and other "unfortunate events" would have occurred. Consequently, despite the potential of better and more timely disclosures during those 35 years, companies would still have been subject to sanctions, fines and civil settlements and restated financial statements. Investors would not have been entirely spared from the serious financial harm and the risks involved with noncompliance with laws and regulations.

Stein's reference to "unfortunate events" raises the question often asked of the auditors, where were the PCAOB (founded in 2002) and the AICPA regarding audit effectiveness[14] over past two decades?

Stein's history lesson, with more than twenty footnotes is interesting and selective. However, as justification and an argument for the Proposal, it is unpersuasive. [15]

Erica Y. Williams and Anthony C Thompson

Note that these two Board members suggest that the Proposal as written, does not mean what it says. Erica Y. Williams (Board Chair) and Anthony C Thompson, say that the Proposal does not mean auditors are required to know every single law or regulation on the books. They quote the same sentence:

> 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.[16]

As noted above, Ho contends that the proper reading of this Proposal requires the auditor to identify all the laws and regulations applicable to the public company, and she cites the above contradictory sentence, which sentence is not in the Proposed standard itself.

Unauthorized Practice of Law

I am uncertain whether, when following the Proposal's requirements, the auditors are providing legal services. Auditors may appear to be giving legal advice, making legal

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[13] Nassim Taleb, author of The Black Swan: The Impact of the Highly Improbable defines Black Swan as "an event with the following three attributes. First, it is an outlier, as it lies outside the realm of regular expectations, because nothing in the past can convincingly point to its possibility. Second, it carries an extreme impact…. Third, in spite of its outlier status, human nature makes us concoct explanations for its occurrence after the fact, making it explainable and predictable."

[14] Regarding "where were the auditors" and the effectiveness of audits, see Panel on Audit Effectiveness (August 31, 2000), p. viii; Remarks by Lynn E. Turner (SEC Staff), November 6, 1998; Garbage In / Garbage Out, Abraham Briloff, April 2001.

[15] The Endnote to this letter addresses one of Stein's quotations and its footnote.

[16] This sentence (pages 22 and 29) is in the introductory "discussion of the proposal."

interpretations, or answering legal questions[17] and may inadvertently be practicing law when communicating with management, the audit committee, or others.

I recognize that the definition of legal services is a question of law, therefore, my uncertainty.

Perhaps other commenters have addressed this question, but for now the proposed procedures appear to require the auditor to unknowingly cross the "providing legal services" line.

Other Comments on the Proposal

Paragraph .01

The first sentence of this paragraph states:

> "Auditors have a fundamental obligation to protect investors through the preparation and issuance of informative, accurate, and independent auditor's reports, and that obligation governs this standard to identify and evaluate information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred and make appropriate communications to management and the audit committee about such information." (Emphasis added.)

The underlined words are new to the PCAOB's standards and obligate auditors to function as external gatekeepers for investors. According to the Proposal, the auditor now "assures" investors that the company is complying with laws and regulations everywhere (worldwide) and that instances of material noncompliance are disclosed or otherwise addressed by the client company. As mentioned above, this is a role that belongs to management.

I understand that the Board has a broad mandate, but as I read the Act[18], it did not impose any "fundamental obligation" on the auditor to identify and evaluate information regarding noncompliance with laws and regulations that "has or may have occurred."[19]

The Proposal's expansion of the auditor's fundamental purpose is viewed as a way to provide "legal services" for the benefit of investors without them hiring lawyers to opine on the conformity and nonconformity of the client's adherence to laws and regulations.

Note that SOX addresses the protection of investors as "AN ACT: To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." (Emphasis added.)

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[17] See paragraphs .13 to .17 of the Proposed amendments.

[18] Sarbanes-Oxley Act of 2002 (SOX) was "AN ACT: To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."

[19] "There is established the Public Company Accounting Oversight Board, to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports." I.101.(a) Establishment of Board.

The standard audit report assumes that the entity has the ability to continue as a going concern for a reasonable period of time (the going concern assumption).[20] While there is no authoritative professional literature stating a similar assumption for "compliance with laws and regulations," it has also been assumed that the client company is operating in accordance with all applicable laws, rules, and regulations.[21]

Footnote 3 to paragraph .01 directs the reader to Section 10A of the 1934 Act. The requirements of this Proposal far exceed those of Section 10A, which only adds to the Proposal's many other flaws.[22]

While Note 3(1) correctly quotes 15 U.S.C. § 78j, footnote 3(2) does not. 15 U.S.C. § 78j(b)(1) requires that if the auditor **detects or otherwise becomes aware** of information indicating an illegal act (ignoring materiality) has or may have occurred, the firm must …. While footnote 3(2) rewrites the 1934 Act by deleting the bolded words.

Paragraphs .03 and .04

Paragraphs .03 and .04 appear to breakdown noncompliance into six categories:

Laws and regulations –

1. that are identified as not being complied with and could reasonably have a material effect
2. that are identified as not being complied with and do not have a material effect
3. where the auditor becomes aware of information that indicates noncompliance has occurred (*i.e.,* already happened) and could reasonably have a material effect
4. where the auditor becomes aware of information that indicates noncompliance has occurred (*i.e.,* already happened) and does not have material effect
5. where the auditor becomes aware of information that indicates noncompliance may (*i.e.,* possibly) have happened and could reasonably have a material effect
6. where the auditor becomes aware of information that indicates noncompliance may (*i.e.,* possibly) have happened and could not have a material effect

These laws and regulations pertain to the company and its consolidated subsidiaries, wherever located, including discontinued operations.

[20] AS 2415.02: The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.

[21] See extant AS 2405, Illegal Acts, and Section 10A of the Securities and Exchange Act of 1934.

[22] See page 28 of the "discussion of the proposal," which tells the reader that "our proposed standard would go beyond the requirements of Section 10A."

The one sentence paragraph .03, contains the following phrases and words: "could reasonably have a material effect on the financial statements[23]," "has or may have occurred,[24]" and "evaluate." A mix of terms guarantees that auditors will not always come to same conclusion using the same set of facts. Is it acceptable that there are two different conclusions drawn from the same evidence, or must one of them be wrong?

To add to the waterfall of subjectivity, paragraph .07(2) compels the auditor to determine the likelihood of noncompliance. So here we have yet another subdivision of noncompliance.

Confounding and blurring the above noncompliance categories, footnote 15 to paragraph .10 tells the auditor that to determine materiality, (a) the auditor must review both qualitative and quantitative factors and (b) evaluate noncompliance both "individually and in the aggregate with similar instances."

The required financial statement disclosures, incorporating all the above factors, would be as of the latest year end and then updated, as a subsequent event, from the balance sheet date to the date the financial statements are issued.

Paragraph .06

Paragraph .06(a)(3) discussing inquiries of management and others should either refer to the Note in paragraph .08,[25] or move that note to this paragraph since this is the first mention of making inquiries.

Paragraph .07

When evaluating noncompliance, paragraph .07 requires the auditor to "determine whether it is likely that any such noncompliance occurred (emphasis added)." This "likely" decision adds the mix of subjectivity discussed above.

This is the first appearance of the word "likely" in this amendment to AS 2405. This word should be changed to "probable," which is defined as "the future event or events are likely to occur."[26]

Paragraph .08

[23] The first paragraph on page 29 of the "discussion of the proposal," loosely defines the subjective phrase "could reasonably have a material effect."

[24] The phrase "may have" is used when the auditor is in doubt.

[25] "… Inquiry alone is not sufficient to determine that noncompliance is not likely to have occurred."

[26] The ASC Master Glossary.

This paragraph requires the auditor to obtain "an understanding about the nature and circumstances of any such noncompliance with laws and regulations ...."

Questions:

> How deep must this understanding be? To understand the nature and circumstances, does it matter whether the auditor is truly knowledgeable, or is it enough to have an awareness of or a familiarity with the law? As mentioned, I agree with Mr. DesParte's dissent to expand "the scope of the audit to incorporate extensive new ... procedures" requiring "legal acumen and expertise well beyond the auditor's core competency."

According to Note 10, "When determining whether similar transactions or events may have occurred, the auditor might determine it is necessary to perform forensic auditing procedures to analyze the company's transactions (emphasis added)." I presume the forensic procedures should follow the AICPA's guidance[27], which is focused on litigation and investigations. Is this what the PCAOB's staff had in mind, or something else?

Paragraph .10

Here, footnote 15 says, "The materiality of likely noncompliance should be evaluated individually and in the aggregate with similar instances."

A hypothetical:

> Assume the auditor becomes aware of or identifies instances of noncompliance with the tax regulations of six jurisdictions, *i.e.,* six countries where there are six subsidiaries (three wholly owned, and three majority owned). These subsidiaries do not meet the test of group audit materiality and are "unaudited." The auditor determines that two instances of noncompliance are probably (or likely) material and four are not.
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> Question: Does footnote 15 require that all six instances of tax noncompliance be aggregated? What additional facts will be needed to aggregate instances of noncompliance?

The Completeness Assertion

The proposed note to AS 2110.10 discusses the expansion of the auditor's quest for information and evidence to areas outside of the financial statements. At present, I do not believe any of these other areas have the internal controls auditors are accustomed to, including the controls over the completeness assertion.

Moreover, I have no direct knowledge about the current state of the internal controls of public companies, as they may relate to the completeness assertion[28] regarding noncompliance– that

[27] Statement on Standards for Forensic Services No. 1, AICPA, 2019.

[28] See AS 1105, Audit Evidence, financial statement assertions.

all transactions, accounts, and disclosures about noncompliance are properly included in the financial statements or elsewhere. I believe that most public companies do not have such internal controls, and therefore, at some considerable cost[29], they would need to establish a formal process to gather the information so that it can be "audited."[30]

More Questions than Answers

How should auditors go about determining the laws and regulations applicable to the registrant that are relevant from those that are not relevant, *i.e.,* laws and regulations with trivial consequences and trivial fines and penalties? The Proposal says that laws and regulations are either complied with or not. But this is not demonstrably true. There are gradations of compliance and gradations of fines and penalties, meaning that not every investor is harmed by a law or regulation that is not completely followed.

What constitutes laws and regulations is only partially answered in the introductory "discussion of the proposal," which gives me some examples:

> monetary sanctions (page 17); money-laundering (page 5); environmental regulations (page 5); restrictions upon business operations (page 10); embezzlement of company funds, misappropriation of assets, payment of bribes, violations of employment, occupational safety, and health, antitrust, privacy (page 24)

Page 5 of the introductory "discussion of the proposal says: "Moreover, our outreach has indicated that the distinction in dividing illegal acts into categories of those with direct effects and those with indirect effects on the financial statements has been a source of confusion to investors. The auditing standards have historically used the distinction to limit the auditors' responsibilities, such that the auditor need only perform certain audit procedures depending on the category."

I question the validity of the widespread confusion among investors concerning the distinction between direct and indirect effects of illegal acts. Why are investors confused? Is there some study that supports this assertion? There should be better outreach to investors explaining about the meaning of direct versus indirect.

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[29] A discussion of the net incremental costs that may be incurred by companies is discussed on page 78 of the introductory "discussion of the proposal."

[30] A note to the proposed amendment to AS 2110.11 discusses just how expansive the auditor's procedures are expected to be.

Endnote

[1] A comment regarding Kara M. Stein's remarks at the June 6, 2023, Open Board Meeting. Among other references, she uses the following quotation as support for the Proposal:

> "The Lawyer's duty is first of all to [the client] …; but the Public Accountant has only one duty to [the] client and to the Public… [to tell] the truth, the whole truth, and nothing but the truth." We are then directed to a footnote which states: "Lawrence Dicksee & Robert Montgomery, *Auditing, A Practical Manual for Auditors* (1905)."

This reference is not correct. The source should be *Auditing a Practical Manual for Auditors*, by Lawrence R. Dicksee, edited by Robert H. Montgomery (1905), and the quote is from the Introduction to this book written by A. Lowes Dickinson.

Further, the full sentence reads:

> "The Lawyer's duty is first of all to his client, and that duty frequently compels him to avail himself of technicalities and other means of enabling that client to evade the Law and its penalties; but the Public Accountant has only one duty to his client and to the Public, and that is to disclose to him or for him 'the truth, the whole truth, and nothing but the truth,' so far as his abilities and special training to that end enable him to ascertain it (emphasis added)."

Here the Public Accountant is locked in the same paragraph with the Lawyer whose duty we are told is the illegal evasion of the "Law and its penalties," so with the hand raised the Public Accountant is duly sworn in as a witness with the "truth oath." What else is there for the Public Accountant to say? Mr. Dickinson had no fallback to AU 1000.14 wherein the auditor need only obtain reasonable assurance not absolute assurance.

This quote is not an argument for adopting this Proposal. I did not review any of the other footnotes.

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Please call or email me using the number or address below if there are any questions concerning this letter.

Sincerely,

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