



August 7, 2023

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

VIA Online submission

Re: Proposing Release: Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations, Docket 051

Dear Secretary Brown and Members of the Board:

The Center for American Progress (CAP or “we”) respectfully submits this letter in support of the Public Company Accounting Oversight Board (PCAOB or “the Board”) proposal entitled, “Amendments to PCAOB Auditing Standards related to a Company’s Noncompliance with Laws and Regulations.”¹

CAP is an independent, nonpartisan policy institute that is dedicated to improving the lives of all Americans through bold, progressive ideas, strong leadership, and concerted action.

Investors need confidence in the integrity of the companies in which they invest. In response to several examples where investors misplaced their trust in companies that were not complying with the law, Congress created the PCAOB for the express purpose of overseeing a key safeguard for investors – audits of public companies. While audit standards are “at the heart of the Board’s mission,”² the gestalt of the audit process is to ensure that companies are who and what they tell investors they are.

An audit should provide reasonable assurance to investors that a company’s financial statements are free of material misstatement, whether due to error or fraud.³ Yet, audits mean little to investors if auditors fail to consider all relevant information to identify noncompliance with laws or regulations or fail to design and implement an appropriate response when they do uncover errors or acts of fraud. Investors cannot

¹ PCAOB, Release No. 2023-003, June 6, 2023.

² Remarks of Kara M. Stein, Member, PCAOB, June 6, 2023, available at <https://pcaobus.org/news-events/speeches/speech-detail/a-return-to-roots-the-auditor-s-role-in-uncovering-and-reporting-illegal-acts>.

³ AS 1001.02, PCAOB, available at <https://pcaobus.org/oversight/standards/auditing-standards/details/AS1001>.

have confidence in audits of public companies if auditors are permitted to ignore relevant evidence or take a “don’t ask, don’t tell” approach to review of the financials.

Existing standards detailing auditor responsibilities in identifying, evaluating, and communicating and reporting possible noncompliance are outdated, given the rapid increase in the risks that companies face today and the corresponding increase in laws and regulations surrounding those risks. In addition, it is increasingly apparent that the existing standards are inadequate at countering strong disincentives that may lead to weak audits. Dozens of cases, like those involving Enron and, more recently, Wells Fargo, have demonstrated this.⁴

The potential effect on company financials of all of these inadequacies means that investors may be relying on material misstatements—a concern that has grown significantly since the standards were last revised in 1988—more than a decade before the Board’s creation.

The proposed rulemaking would make significant progress on updating and correcting the inadequacies of the existing standards, enhancing audit quality, and mitigating significant negative influences on auditors today. This, in turn, would greatly improve investor protection.

Decades of Costly Failures Warrant a Robust Update

The global business environment in which today’s companies operate has become far more complex over the past several decades. People, products, and services move faster than ever, and communication is virtually instantaneous. Capital markets are changing continually, as is the work environment and consumer behavior. Governments at all levels must ensure protection of consumers and investors in this rapidly changing environment, which requires laws and regulations to be developed and updated regularly. The fast pace and complexity of today’s business environment can also create pressures on auditors to take shortcuts, turn a blind eye, or simply rush audits, with resulting errors. It can even invite fraud. At the same time, for issuers and auditors alike, tools for keeping abreast of laws and regulations are more sophisticated than ever.⁵

As the proposal makes clear, depending upon their business, a company may be subject to laws and regulations that reasonably can materially affect the financial

⁴ See, e.g., “Lessons from the Enron Scandal,” Markkula Center for Applied Ethics, Santa Clara University, March 5, 2002 (interview of Kirk Hanson, executive director); and Francine McKenna and Andrea Riquier, “Where was KPMG, Wells Fargo’s auditor, while the funny business was going on?” MarketWatch, August 21, 2017, available at <https://www.marketwatch.com/story/where-was-wells-fargos-auditor-kpmg-while-the-funny-business-was-going-on-2017-08-17>.

⁵ See Stein, June 6, 2023, for a discussion of technological advances in corporate reporting and the audit that will improve auditor analysis and provide information relevant to the audit.

statements. For investors, the audit is the final check point for identifying potential material legal or regulatory noncompliance that may impact the financial statements. A positive audit report tells investors that they can reasonably rely on the company's financial statements.

But events over the past several decades since the last revision of the noncompliance auditing standards have repeatedly shown that investors' reliance may be misplaced, that even the most egregious legal and regulatory noncompliance with catastrophic implications for the company and ultimately the investment and retirement portfolios of millions of Americans may go unnoticed, unreported, or unaddressed.

Virtually all of the financial crises and failures of recent decades have involved some degree of audit failure, including the savings and loan crisis of the late 1980s and early 1990s,⁶ the Enron bankruptcy of 2001,⁷ the WorldCom scandal,⁸ the global financial crisis,⁹ and the recent failure of mid-sized US banks.¹⁰ Some of the noncompliance issues in these cases went undetected for years, compounding the ultimate financial fallout for the companies involved.

While not perfect, the proposed rulemaking would be a major step forward in updating current standards for auditors as they identify, evaluate, and decide how to communicate potential noncompliance with laws and regulations that could materially affect a company's financial statements.

The proposal would update and correct many inadequacies of existing standards

The proposal better reflects Congress's intent, expressed through the passage of the Sarbanes-Oxley Act and the creation of the PCAOB, to protect investors and enhance corporate responsibility. For example, it expands the explicit requirements of Section

⁶ Robert A. Rosenblatt, "Auditor Pays \$400 Million for Not Signaling S&L Crisis," Los Angeles Times, November 24, 1992, available at <https://www.latimes.com/archives/la-xpm-1992-11-24-mn-1128-story.html>.

⁷ Reed Abelson and Jonathan D. Glater, "Enron's Collapse: The Auditors; Who's Keeping the Accountants Accountable?" The New York Times, January 15, 2002, available at <https://www.nytimes.com/2002/01/15/business/enron-s-collapse-the-auditors-who-s-keeping-the-accountants-accountable.html>

⁸ Javiriyah Sshraf, "The accounting fraud at WorldCom: the causes, the characteristics, the consequences, and the lessons learned," University of Central Florida, 2011, available at <https://stars.library.ucf.edu/cgi/viewcontent.cgi?article=2106&context=honorstheses1990-2015>.

⁹ Jonathan Ford and Madison Marriage, "The Big Flaw: Auditing in Crisis," Financial Times, August 1, 2018, available at <https://www.ft.com/content/29ccd60a-85c8-11e8-a29d-73e3d454535d>.

¹⁰ Atul Shah, "US banking failures: the role of big auditors in another financial crisis," City, University of London, May 31, 2023, available at <https://www.city.ac.uk/news-and-events/news/2023/05/us-banking-failures-the-role-of-big-auditors-in-another-financial-crisis>.

10A of the Securities Exchange Act of 1934¹¹ to cover audits of SEC-registered brokers and dealers.

It also accounts for many of the lessons learned from the series of crises and failures that have occurred in recent decades. It does so by changing the term “illegal acts” to “noncompliance with laws and regulations” and makes clear that fraud is a type of noncompliance with laws and regulations.

In addition to addressing these inadequacies of the existing rule, the proposal would simplify and simultaneously clarify the auditor’s task by eliminating the confusing distinction between direct and indirect impacts on the financial statements, so that the auditor focuses on those laws and regulations with which noncompliance could reasonably result in a material effect on the financial statements.

The proposal would enhance audit quality and protect investors

The proposal would improve audit quality by enhancing the auditor’s identification, evaluation, and communication of noncompliance with laws and regulations. It would also lead to more consistency in auditor practices. These improvements would lead directly to better informed and better protected investors. And we strongly agree that the auditor should be required to look at an expanded set of sources external to the company when assessing the possibility of material misstatement.

The proposal would counteract some of the negative influences on auditors

While it will take much more to address the weaknesses in business culture that can have a detrimental impact on the audit, the proposal takes some important steps in the right direction. For example, it expressly states that the auditor must make specific inquiries of management, the audit committee, internal audit personnel, and others. And the proposal requires the auditor to evaluate whether noncompliance has occurred and to communicate potential noncompliance to management and the audit committee. Making these actions explicit removes any doubt that they are essential to an effective audit.

Recommendations

The Board should work to ensure that investors can have confidence in the companies in which they invest, including that those companies are in compliance with laws and regulations. Standards should not allow auditors to ignore evidence and should require adequate elevation of concerns to ensure that investors are apprised of problems; otherwise, investors cannot have the confidence they need.

¹¹ 15 U.S. Code, Section 78j-1, available at <https://www.law.cornell.edu/uscode/text/15/78j-1>.

Investors' dependence on auditors is perhaps most pronounced in areas where laws and regulations are changing, such as those relating to climate and sustainability.¹² Under the proposal, auditors would be required to consider climate and sustainability matters where noncompliance could reasonably have a material effect on the financial statements. In determining materiality, consideration must be made of both qualitative and quantitative factors, including the potential effects of reputational harm. Negative impacts on a company's financials can come in the form of fines, liability, and other costs associated with climate-related legal and regulatory noncompliance. These may sometimes be modest in amount but qualitatively material, particularly given the impact on corporate reputation.

The proposal would require audit firms to consider a wide array of public disclosures, including sustainability reports. They would be obligated to consider whether statements in the reports were inconsistent with, or contradictory to, the financial statements.¹³ Companies seeking to maintain market share and enhance profits have incentives to provide investors and the public with assurances about their climate ambitions and other sustainability-related practices, even as their financial statements may reveal a failure to make the necessary investments to follow through on those representations or rely on assumptions different from those in the sustainability report. We recommend that the final standard make clear that these inconsistencies and contradictions be communicated to the audit committee.

Sustainability reports also may contain misstatements. The proposal would require that auditors perform additional procedures when uncovering possible misstatements but only in documents containing audited financial statements. We believe that this requirement should be extended to other documents, including sustainability reports.

Finally, the proposal requires significant communication to the audit committee. Auditors, however, need not communicate matters deemed "clearly inconsequential." We recommend the elimination of this undefined exception. Auditors may well find examples of noncompliance at formative stages. Management may have additional sources of information that demonstrate the importance of the information. Yet by

¹² See, for example, the European Commission's Corporate Sustainability Reporting Directive, in force as of January 5, 2023, and available at https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en; and the International Sustainability Standards Board's IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information and IFRS S2 Climate-related Disclosures, released June 26, 2023, and available at <https://www.ifrs.org/news-and-events/news/2023/06/issb-issues-ifrs-s1-ifrs-s2/>.

¹³ 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.").

characterizing the matter as “clearly inconsequential,” auditors can avoid reporting the matter to the audit committee.

Similarly, auditors need not communicate matters that were given to the audit committee “in writing” by management. This exception should also be eliminated. Management may do so in lengthy and undifferentiated reports. Information provided by the auditor will, at least in some cases, receive greater prominence.

These two exceptions add a confusing and unnecessary layer to the auditor’s duties and could invite unnecessary auditor discretion and delay detection of noncompliance.

Conclusion

We applaud the Board and its staff for their work in developing and advancing this proposal. After so many decades of crises in which auditing played a role in the failure to check noncompliance with laws and regulations, a substantial update and enhancement of the audit standard on noncompliance is both welcome and overdue. If finalized in its current or an even stronger form, it will go a long way toward rebuilding trust in the audit.

Please address any questions regarding the above comments to Alexandra Thornton, Senior Director, Financial Regulation, at athornton@americanprogress.org.

Sincerely,

Center for American Progress