



THE AUDIT COMMITTEE COUNCIL

July 25, 2023

By email: comments@pcaobus.org

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

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

Dear Office of the Secretary:

This letter represents the views of the Audit Committee Council (ACC) regarding the Public Company Accounting Oversight Board's [proposing release](#), *Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments* (proposed amendments or NOCLAR proposal).¹ The ACC is an independent advisory committee of the Center for Audit Quality comprised of independent audit committee members, including audit committee chairs.

We, as audit committee chairs and members, share the concerns raised by PCAOB Board Members Duane DesParte and Christina Ho in the PCAOB's June 6, 2023, open meeting.²

The Role of the Audit Committee

Sarbanes-Oxley has been successful because its provisions recognize that audit quality is not solely the responsibility of auditors and there is not one stakeholder in the US financial reporting ecosystem who alone can produce high quality financial reporting and high quality audits. Rather, it takes the roles of company management, audit committees, auditors, and regulators working in concert to foster a system that supports both high quality financial statements and audits, all for the protection of investors.

It is in that investor protection role that audit committee chairs and members and the PCAOB have a shared mission. As a result, we are supportive of the PCAOB's strategic plan that has been built to help the PCAOB fulfill its investor protection mission. However, we are concerned that the proposed amendments in the NOCLAR proposal are significantly broad in scope, task the auditor with responsibilities for which they do not have the expertise, and will come at a significant cost without a commensurate benefit for what it seems the PCAOB is attempting to accomplish.

¹ See PCAOB Release No. 2023-003.

² See public statements from Board Members [Duane DesParte](#) and [Christina Ho](#).

Comments

We are supportive of the PCAOB modernizing auditing standards that support auditors in executing audit procedures that are fit for purpose in today's complex business environment and ultimately foster high quality audits. However, we are concerned that the proposed amendments would significantly expand the auditor's responsibilities with respect to noncompliance with laws and regulations (NOCLAR). We are concerned that the proposed amendments may distract the auditor from material audit issues and negatively impact a company's ability to meet filing deadlines which could disrupt the timely distribution of financial data to the capital markets. We suggest a better approach that is risk-based; an approach where the auditor considers the role that the company's compliance program plays in detecting NOCLAR that could be material to the audited financial statements.

Our key comments include:

Proposed scope is too broad

The proposed amendments would require auditors to identify the "laws and regulations with which noncompliance could reasonably have a material effect on financial statements."³ To do this an auditor would first be required to identify all the laws and regulations applicable to the company. The largest of public companies are subject to a vast number of laws, regulations, etc. A large public company in a highly regulated industry can be subject to hundreds of new laws and regulations each year. Moreover, as discussed further below, many public companies already have extensive compliance functions designed to perform this exact function, in part to enable public company management to sign quarterly and annual (as applicable) certifications – such as disclosure controls and procedures (DC&P) and internal control over financial reporting (ICFR) – that the financial statements are presented fairly in all material respects and that the reports do not contain any material misstatements or omissions. It seems the PCAOB is suggesting the external auditor engage in similar and duplicative processes. This would be further exacerbated when considering large multi-national companies subject to laws and regulations globally. Many large companies employ hundreds to thousands of attorneys plus external counsels to monitor, identify, and respond to regulatory requests, subpoenas, and where necessary investigate potential violations of laws and regulations.

Whistleblower hotlines alone raise thousands of matters each year. For example, according to a report from Navex, there were 1.52 million whistleblower reports in 2022 (across 3,430 organizations and 52 million employees).⁴ The median overall substantiation rate, meaning allegations that when investigated prove to be correct or partially correct, was 41% (i.e., majority of allegations were unsubstantiated).⁵ Allegations, even when substantiated, are rarely, if ever, material to the financial statements. In a report from Navex, only 2.12% of complaints related to accounting, auditing and financial reporting issues in 2022.⁶ The proposed amendments could substantially change the expertise needed by the auditor to

³ See proposed AS 2405.06.

⁴ See Navex report, *2023 Risk & Compliance, Hotline & Incident Management, Benchmark Report*.

⁵ Ibid.

⁶ Ibid.

evaluate allegations⁷ that cut across subject matters beyond financial reporting and significantly expand the time required by management and the audit committee.

Auditors are not lawyers

As a result of the above, the proposed amendments would expand the role of the auditor to require skills, knowledge, and expertise that likely lie outside the auditor's core competencies and expertise. Laws and regulations are typically written by attorneys. Broadening the scope of the laws and regulations for which the auditor considers whether non-compliance could reasonably have a material impact on the financial statements beyond the finite laws and regulations for which auditors have an understanding (e.g., financial, tax, etc.) does not seem to be consistent with the objectives of a financial statement audit. While understanding the process and controls surrounding legal and compliance may be a reasonable expectation, auditing and drawing conclusions on that process for all laws and regulations (beyond those that are material to the financial statements) would require a skill and expertise beyond that of the typical external audit team.

Existing three lines of defense within companies

By design a significant control element of compliance with laws and regulations appropriately rests with the three lines of defense within corporations. The results of those processes are regularly reported to the audit committee, as well as to the external auditor for their input regarding the process and evaluation of any significant matters. According to a survey from the Association of Certified Fraud Examiners, the top three detection methods (approximately 70% of frauds detected) were as a result of tips (42%), internal audit (16%), and management review (12%).⁸ In comparison, external auditors detected 4% of frauds.⁹ External auditors do not represent a large percentage of identified frauds because compliance programs are operating at a sophisticated level such that wrongdoings and/or potential wrongdoings are detected independent of the external auditor's procedures.

Increase risk to legal privilege

The auditor's proposed expanded responsibility to identify, evaluate, and report on compliance with laws and regulations would impact the evidence auditors will need to evaluate to support their conclusions. Further, company management will need to design and implement controls to support providing auditors with evidence that enables auditors to audit the information. Notably, too, the increased sharing of information from the audit client to the auditor that is required under the proposed amendments would increase risk to the legal privilege issuers have with their internal and external counsels.

Proposal will substantially increase the cost of the audit

The expanded scope of the proposed amendments would have a substantial impact on the costs of the audit. For example, the PCAOB's NOCLAR proposal explains that "[a]uditors would likely need to expend considerable additional audit effort to identify relevant laws and regulations under the proposed

⁷ Allegation issues included in the Navex benchmark report include topics such as data privacy, human rights, political activity, workplace civility, health and safety, etc.

⁸ See ACFE report, *Occupational Fraud 2022: A Report to the Nations*.

⁹ Ibid.

standard” and that “the costs associated with the proposed amendments...may be substantial.”¹⁰ However, the PCAOB does not provide or quantify the potential costs. According to Audit Analytics, total audit fees for FY 2021 were \$15.5 billion; the average SEC registrant paid \$2.176 million in audit fees, which represents a \$340,000 or 1.5 percent increase over FY 2020.¹¹ The modest increase in fees paid in FY 2021 can be attributed in part to the fact that there were minimal changes in accounting and auditing standards at that time and thus minimal scope changes in the audit relative to new standards or requirements. The NOCLAR proposal has the potential to introduce a significant increase in audit effort and thus audit fees, similar to the extensive change in the scope of the audit as a result of the implementation of the new auditing standard on internal control over financial reporting with the adoption of the Sarbanes-Oxley Act of 2002 (SOX). Between FY 2003 and FY 2004, total audit fees increased by nearly 59%.¹² If the proposed changes have at least the same impact to the scope of the audit as SOX, total audit fees could increase to \$24.6 billion (an increase of \$9.1 billion).

As acknowledged by the PCAOB in its proposal auditors may need to confer with specialists, including a range of legal experts, to comply with the proposed standard. Lawyers’ billing rates are high, and these costs would be passed along to the public company. It is hard to estimate what these costs would be. For example, according to a Wolters Klowers report,¹³ the typical large corporation in their dataset spent around 0.4 percent of company revenue on outside counsel. Illustratively, if you assume half of those legal costs incurred related to a company’s compliance with laws and regulations, the cost of legal experts working for the audit team could be an additional \$74 billion.¹⁴ Between increased auditor time and legal expertise needed this could be a \$83 billion increase in audit fees paid by companies to auditors (approximately 5.3 times FY 2021 audit fees).

These additional costs that would be borne by the auditor do not account for any increased costs that companies would incur for their internal and external counsel, finance teams, and related business units.

Recommendations

Any change should keep the auditor focused on NOCLAR that could materially impact the financial statements. For example, material penalties, loss contingencies, etc. Existing U.S. GAAP addresses requirements for recording loss contingencies related to penalties, fines, and/or lawsuits associated with NOCLAR. U.S. GAAP describes a likelihood continuum from probable, to reasonably possible, to remote.¹⁵

Oversight of the company’s compliance with laws and regulations is a responsibility of the board that is sometimes delegated to the audit committee. In some organizations oversight of compliance may be delegated to a committee other than the audit committee. Boards (and audit committees when responsible) place reliance on the chief compliance officer and general counsel’s assertions that the company is in compliance with all laws and regulations. Any proposed requirements on the auditor

¹⁰ See PCAOB Release No. 2023-003.

¹¹ See Audit Analytics Report, *Twenty Year Review of Audit and Non-Audit Fee Trends*.

¹² Ibid.

¹³ See <https://www.wolterskluwer.com/en/expert-insights/legalview-insights-legal-spend-is-up-but-spread-among-fewer-vendors>.

¹⁴ Using revenue data from Audit Analytics (FY 2021 revenue of \$37 trillion multiplied by 0.4% = \$148 billion divided by 2 = \$74 billion).

¹⁵ See FASB Accounting Standards Codification 450.

should be anchored in directing the auditor to perform risk-based procedures that consider management's conclusions (with their audit committee's oversight) with respect to NOCLAR.

We strongly support the PCAOB's objective to adopt standards that meaningfully improve audit quality and protect investors. We encourage continuous engagement with all the stakeholders in the financial reporting ecosystem at various stages of a project's life (e.g., prior to a proposal, post proposal, etc.). This engagement should be in addition to discussions and recommendations from the PCAOB's advisory groups.

Finally, we encourage the PCAOB to make the standard setting process more accessible; for example, providing a summary of what aspects of the proposal are important to audit committees and where the PCAOB would appreciate audit committee input. Methods for obtaining input from all stakeholders, including audit committee chairs and members, should go beyond the comment letter process to include audit committee roundtables, individual outreach, and surveys. These methods could make the standard setting process more accessible to audit committee chairs and members to obtain input prior to a significant proposal such as NOCLAR.

As the Board gathers feedback from other interested parties, we would be pleased to facilitate a meeting of the Audit Committee Council with the Board regarding the views expressed in this letter. Please address meeting requests to hello@thecaq.org.

Sincerely,

Members of the Audit Committee Council

cc:

PCAOB

Erica Y. Williams, Chair

Duane M. DesParte, Board member

Christina Ho, Board member

Kara M. Stein, Board member

Anthony C. Thompson, Board member

Barbara Vanich, Chief Auditor

SEC

Paul Munter, Chief Accountant

Diana Stoltzfus, Deputy Chief Accountant