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Independent Member Crowe Global

August 7, 2023

By email: comments@pcaob.org

Ms. Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 51: *Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments* (PCAOB Release No. 2023-003)

Dear Ms. Brown:

Crowe LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or "the Board") proposed amendments to the auditing standards related to an auditor's consideration of a company's noncompliance with laws and regulations (NOCLAR) in the performance of an audit and other related amendments ("proposal", "proposed standard", or "proposed auditing standard").

General Observations

We are committed to promoting the highest standards of audit quality to help support the integrity of the capital markets. We believe there are opportunities to enhance audit quality related to the identification and assessment of risk of material misstatement to the financial statements arising from NOCLAR.

We have significant concerns, however, with several elements of the Board's proposal. We are concerned that there will be substantial challenges for auditors to comply with the expanded scope of the financial statement audit put forth in the proposal, whether due to challenges in identifying and engaging specialists that have the necessary knowledge and expertise of applicable laws and regulations or with the requirement that auditors search for information other than that provided by the registrant. Additionally, we are concerned about the proposal's requirement to determine whether it is likely that any noncompliance occurred without regard to the contextual language provided in AS 2405. Determining noncompliance with the law is a legal determination; the auditor does not possess the professional competence nor the professional authority to make this determination. We are also concerned that without an appropriate focus on the impact of a potential act of NOCLAR on the financial statements, we believe auditors and management are likely to expend significant time evaluating matters where either noncompliance has not occurred, or noncompliance has occurred and there is not a material effect on the financial statements.

Finally, we are concerned the proposal creates requirements for auditors that go beyond the requirements of management under federal securities law and generally accepted accounting principles and also conflates the roles of management and the auditor in the identification, evaluation, and communication of NOCLAR. Without alignment of management and auditor requirements and recognition of management's responsibility for the preparation of the financial statements, the proposal could expand the expectations gap with investors and other stakeholders about the role of the auditor in the area of NOCLAR and rather than act to the benefit of investors, to the contrary, cause information misallocation or misunderstanding in the public markets.

We address each of these concerns in more detail below.

Specific Areas of Comment

Need for Coordination with SEC and FASB

The proposal is intended to promote audit quality by enhancing the identification, evaluation and communication of NOCLAR, including noncompliance related to consumer and environmental laws and regulations or other laws and regulations related to the company's operations. As the release indicates, failures to comply with the applicable laws and regulations can result in penalties, fines, damages or other material adverse consequences to the company and consequential harm to investors.

In the area of compliance with laws and regulations, it is important to acknowledge the responsibility of management both to establish policies and procedures so that applicable laws and regulations are complied with and to monitor for and address instances of noncompliance.

To the extent there is a need for changes to company's identification, assessment and reporting of NOCLAR, it is fundamentally a disclosure issue that rests predominately with management. Accordingly, it would be prudent and efficient for changes to be considered through the disclosure rules. For example, the PCAOB could discuss their concerns with the US Securities and Exchange Commission (SEC), who can assess whether management's requirements for reporting instances of noncompliance under federal securities laws and the scope of illegal acts that are required to be addressed continue to be sufficient and appropriate. Likewise, the PCAOB could discuss concerns with the Financial Accounting Standards Board (FASB), who can assess if changes are needed to the current requirements for disclosure and recognition of the financial impacts from NOCLAR under general accepted accounting principles, including accounting for contingencies. Without also driving changes to management's financial reporting requirements, we believe there is risk of expanding the expectations gap related to the roles of management and the auditor in the area of NOCLAR, as well as introducing the risk of independence violations as discussed further below.

Inappropriate Expansion of the Scope of the Audit Related to NOCLAR

Overall, we believe the Board's proposal changes the scope of the financial statement audit related to NOCLAR. Proposed AS 2405.01 discusses the objective of the auditor is "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." This objective moves the focus from evaluating the impact of noncompliance on the financial statements to identifying noncompliance with laws and regulations *before* the determination of whether there is an impact to the financial statements. Under the proposed standard, there is no longer a need for the law and regulation to have a direct impact on the financial statements. Along with this change in focus, there is also an explicit expansion of the population of the laws and regulations that auditors need to evaluate the company's compliance with, including environmental, occupational safety and health, privacy laws and regulations, antitrust and the Foreign Corrupt Practices Act, whether national laws, or that of a smaller governmental organization. With the focus on identification of noncompliance with laws and regulations without consideration of the financial statement impacts, auditors will be required to significantly increase the scope of their procedures related to NOCLAR, regardless of the risk of material misstatement to the financial statements similar to that of a compliance audit or attestation. To the extent management, the audit committee, or other stakeholders need assurance about an entity's compliance with laws and regulations, a separate compliance attestation engagement could be performed for that purpose. By indicating that the objective of the financial statement auditor is to identify whether there are instances of NOCLAR, inserting attestation-like procedures into the financial statement audit and eliminating discussion about the auditor's ability to identify and assess noncompliance[1], the Board is significantly expanding the role of the auditor and potentially creating confusion on the role and responsibility of the auditor in the area of NOCLAR.

In the release, the Board states "the objective of our proposed standard does not include a distinction between laws and regulations that have a direct or an indirect effect on the financial statements." Instead, the proposed standard would require the auditor to focus on laws and regulations with which noncompliance could reasonably result in a material effect on the financial statements. We believe the focus should continue to be on the impacts of NOCLAR to the financial statements, including evaluating whether the company has properly identified, recorded and/or disclosed a contingent liability. As noted in AS 2405, illegal acts are indirect because "their indirect effect is normally the result of the need to disclose a contingent liability because of the determination of illegality." In these situations, there <u>would</u> be a reasonable risk of material misstatement to the financial statements because the act has been determined to be illegal and the act results in a required disclosure of a contingent liability under Accounting Standards Codification ("ASC") 450. Without this link to the impact on the financial statements, the auditor may spend a significant amount of time evaluating potential violations of laws and regulation that would not reasonably result in a material effect on the financial statements.

We believe the existing standards provide this link. The requirements in existing AS 2405.10 that discuss how illegal acts (NOCLAR) intersect with the objective of the auditor in an audit of the financial statements: "the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit." Similarly, as fraud would be included within the proposed definition of NOCLAR, we believe existing AS 2401.05 also demonstrates this link and states: "Fraud is a broad legal concept and auditors do not make legal determinations of whether fraud has occurred. Rather, the auditor's interest specifically relates to acts <u>that result</u> in a material misstatement of the financial statements."

We recommend that the proposed standard be revised to clarify that the objective of the auditor in the area of NOCLAR is to identify and evaluate the material effect of NOCLAR on the financial statements. There should be no risk of confusion from users of the financial statements that the auditor is performing procedures similar to a compliance audit related to NOCLAR or otherwise performing procedures to identify instances of NOCLAR that do not have a material effect on the financial statements.

<u>Challenges for Auditors due to the Proposed Expansion of the Audit</u>

Given the emphasis in the proposed standard on the identification of laws and regulations; the population of local, state, federal and international laws that companies are subject to; and the continuous change in laws and regulations; we believe it will be impractical for auditors to accumulate a complete population of laws and regulations with which noncompliance could reasonably have a material effect on the financial statements. As a starting point, the proposed standard requires the auditor to identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements. To satisfy this requirement, we believe auditors will need to first identify <u>all</u> laws and regulations that the company needs to comply with *before* evaluating which could reasonably have a material effect on the financial statements. To further demonstrate the expansion population of laws and regulations, the definition of NOCLAR includes "any rule or regulation having the force of law", which would mean any law or regulation that could be enforced by the government or private individual is covered by the proposal. To accumulate the complete population of such laws and regulations, multiple specialists will be required to assist in the identification process. For example, we audit many financial

[1] See further discussion on the elimination of this discussion under Challenges to Determine the Occurrence of Fraud or Illegal Acts

institutions with locations in multiple states that are subject to thousands of local, state, and federal banking rules and regulations. In addition, some of these financial institutions may have subsidiaries that operate as broker-dealers and insurance companies; these subsidiaries are each subject to different local, state, and federal laws. It will be challenging to effectively and efficiently identify specialists that have an understanding of the full range of laws and regulations that relate to the company's operations. There may even be challenges to identify specialists that have the necessary expertise to identify relevant laws and regulations in unique or uncommon areas.

We think there will be similar resource constraints on the company to identify resources with a full understanding of laws and regulations. Some companies may have in-house counsel that works with compliance to identify laws and regulations that the company is subject to and monitors changes and interpretations in the laws and regulations; however, many public companies do not have in-house counsel and solely rely on external firms to handle these responsibilities. The inability of companies to identify resources with a full understanding of laws and regulations will impact the completeness and accuracy of information provided by management on laws and regulations; the potential for incomplete and inaccurate information will create challenges for the auditor in the identification of relevant laws and regulations.

After identifying the population of laws and regulations with which the company needs to comply, the auditor would then evaluate which laws and regulation's noncompliance could reasonably have a material effect on the financial statements. We expect there to be significant challenges in eliminating the laws and regulations where noncompliance could *not* reasonably have a material effect on the financial statements. Auditors would need to consider the range of possible violations of the laws and regulations and the resulting range in possible effects from that noncompliance. Auditors may not be able to conclude that all noncompliance of a particular law or regulation would not be material; as such, very few laws and regulations will be excluded from the population that the auditor evaluates. As a result, we believe auditors will expend disproportionate effort into auditing potential noncompliance with laws and regulations that may not have a material effect on the financial statements, resulting in significant additional costs to the audit. In addition, there will likely be ineffectiveness and inefficiencies in the area of noncompliance on audits due to the extensive population of laws and regulations that the auditor will be evaluating.

In addition, the proposal indicates that, "...noncompliance with laws and regulations by companies may result in substantial financial damage to investors through lower share prices. In addition to sanctions and fines, civil settlements, and legal costs, share prices may also be affected by reputational consequences for the companies, including lower future earnings and increases in the cost of capital." While an auditor *may* be able to assess the potential impact to the financial statements of sanctions, fines, settlements and legal costs in the context of determining whether the current period financial statements are materially misstated, an auditor *would not* be able to predict, nor to identify specific risks of material misstatement to the set of financial statements being audited related to, reputational harm or a decline in share price.

The economic analysis identifies a potential unintended consequence that auditors may "overreact" and retain legal counsel or other specialists even when doing so is unnecessary to obtain sufficient appropriate audit evidence. We, however, do not know how the auditor would implement the proposed standard without engaging specialists to assist with the identification and assessment of relevant laws and regulations, given these are not the auditor's areas of expertise. Even identification of laws and regulations will require input from specialists given the breadth of applicable laws and regulations that are within the scope of the proposed standard. If auditors are required to determine whether noncompliance occurred, most auditors will retain legal counsel or other specialists to assist in the evaluation of laws and regulations that apply to the company's operations. We don't view this as "overreacting" or an "unintended consequence;" we view this as exercising due professional care.

In obtaining audit evidence related to illegal acts, auditors often will receive an audit inquiry letter from an attorney that covers the matter and can based upon that determine whether accrual or disclosure is required under ASC 450. Attorneys undertake representation only on certain specific matters and make a commitment only to comment on disclosure matters when matters come to their attention in the scope of their work. Attorneys do not search through a company's transactions to find disclosure issues on matters on which they are not representing the company. However, the proposed new standard may require the auditor's response to include forensic auditing procedures on whether there are matters which involve violations of law, but which do not directly have a material effect on the financial statements. This would extend the auditor's requirement beyond the requirements of the company[2].

Notwithstanding our fundamental concerns around the proposed requirement for the auditor to identify and assess laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, we are supportive of the auditor performing additional procedures to identify potential indicators of NOCLAR and not just relying on information obtained from management. As discussed earlier, management has responsibilities in the area of noncompliance with laws and regulations, but the auditor should demonstrate a level of professional skepticism in performing procedures to address the completeness of management's listing of noncompliance with laws and regulations.

As a result of these concerns, we do not believe the proposed standard should be adopted as released. However, we suggest the standard include matters for the auditor to consider that may be indicative of NOCLAR, such as payment of fines or penalties, and noncompliance with laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor.

Challenges to Determine the Occurrence of Fraud or Illegal Acts

Auditors are proficient in accounting and auditing but do not generally have expertise related to the multitude of laws and regulations with which a company needs to comply, or in assessing whether noncompliance has or may have occurred. Existing AS 2405 states "illegal is a determination that is normally beyond the auditor's professional competence" and "the determination as to whether a particular act is illegal would generally be based on the advice of an informed expert." Within the economic analysis section of the release, the Board indicates this language has been removed as it doesn't speak to the auditor's affirmative obligations.

The inherent limitations of the auditor are further acknowledged by the Board in AS 2401.05 which provides a description and characteristics of fraud (which will be included in the definition of NOCLAR under the proposal) and states: "Fraud is a broad legal concept and auditors to do not make legal determinations of whether fraud has occurred." We believe the language from existing AS 2405 provides greater transparency about the role and responsibilities of the auditor with regard to NOCLAR, which is to identify and assess risks of material misstatement arising from NOCLAR and if such risks are identified, to design audit procedures to address the risk of material misstatement arising from NOCLAR.

A determination of whether noncompliance has occurred is a legal determination that is likely to be made by lawyers, not by auditors who lack the experience and knowledge to understand the relevant provisions of the laws or regulations. If the auditor doesn't understand the relevant provisions of laws and regulations, it is difficult to identify and assess the risk of noncompliance. We believe that the expectations gap for auditors in the area of NOCLAR will be exacerbated by the combination of a) the removal of language from the existing standard that discusses the inherent limitations for auditors to assess compliance with laws and regulations (when the inherent limitations will continue to exist under the proposed standard); b) the inclusion of language that portrays the auditor as the initial party to identify, evaluate and communicate noncompliance; and c) the insertion of procedures, similar to that of a compliance audit or attestation, that are focused on determining noncompliance into the financial statement audit.

Further, it may not be possible for a financial statement auditor to execute the expanded role the PCAOB created in the proposal with respect to evaluating whether noncompliance occurred. From our experience in dealing with various regulatory agencies as well as external counsel, these third parties are often willing to engage in discussions about the status of regulatory examinations; however, they may not

[2] See further discussion of inquiries with attorneys within AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation*.

be willing to provide details around the regulator's conclusions on the matters with other third parties, such as the external audit firm, prior to the completion and issuance of their report.

In discussing potential noncompliance with legal counsel, there may be attorney-client privilege that prevents the company's specialists from disclosing a conclusion on whether instances of NOCLAR have or may have occurred. Auditors are required to obtain sufficient appropriate audit evidence to satisfy their obligations under AS 2405 and Section 10A related to instances of noncompliance of which they become aware, while a company's internal and external counsels have an obligation to preserve attorney-client privilege and to protect the company from inadvertent waiver of this privilege. These potentially conflicting demands of the legal and accounting professions are currently governed by the American Bar Association (*ABA) Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*. The ABA statement strikes a delicate balance between avoiding potential waivers of attorney-client privilege and responding to auditor's needs for information to provide assurance on clients' financial statements, as there is a natural tension between these competing demands. The ABA views a key contributor to its longevity to be that its development was premised on some basic ground rules. These ground rules place limitations on the information that can be provided to the auditor in an audit response letter, including limitations based on things such as: the amount of attention the lawyer has devoted to the matter; the lawyer's assessment of the likelihood of a loss contingency; the client's determination as to the likelihood that a possible claim will be asserted, the expected outcome, and the expected materiality of a resulting liability. The proposal, if adopted, will result in an exponential increase in the amount of information auditors will require from companies and their internal and external counsel related to potential NOCLAR, not all of which may fall within the ground rules of the ABA statement, which would pose significant challenges for auditors in obtaining sufficient information to satisfy their obligations.

There may be laws and regulations over these third parties in certain jurisdictions that do not allow disclosure of NOCLAR with third parties, such as audit firms. As such, the auditor may not be able to obtain persuasive audit evidence on whether NOCLAR has or may have occurred.

From our experience, it may take an extended period of time for management to determine whether NOCLAR has occurred. When potential NOCLAR is identified, there is frequently an extended period for review and evaluation of the facts and circumstances. This may last for months, or even years. We often find that legal counsel (both internal and external) is unwilling to acknowledge if NOCLAR has likely occurred until there is resolution of the matter. In these situations, management will perform an evaluation of whether the matter requires disclosure and/or accrual in the financial statements in accordance with accounting and regulatory requirements and, as part of the audit, the auditor will also evaluate whether management's conclusions are reasonable and appropriate. The auditor is not, however, able to conclude on whether NOCLAR has likely occurred.

We recommend the Board recognize the potential limitations to the auditor's ability to obtain sufficient appropriate audit evidence related to whether NOCLAR has occurred. Our recommendation is to, focus the auditor's attention on evaluating the impact of noncompliance on the financial statements. This will allow the auditor to focus the audit effort on obtaining sufficient appropriate audit evidence related to management's recording and disclosure of the impact of noncompliance in accordance with generally accepted accounting principles related to contingent liabilities.

<u>Expansion in Scope of Illegal Acts/NOCLAR Beyond Section 10A</u>

Section 10A of the Securities Exchange Act of 1934 ("Section 10A") requires the auditors of issuers to include audit 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. Section 10A, which was finalized almost 30 years ago, took nearly 10 years of debate through congressional hearings and other forums. Most of the debate was focused on the scope of illegal acts to be covered within Section 10A.

In the release, there is discussion that the proposed standard would go beyond the requirements of Section 10A to require the auditor to focus on laws and regulations with which noncompliance could reasonably result in a material effect on the financial statements. However, there is no discussion within the release, including in the economic analysis, on why the Board believes the requirements of Section 10A are not sufficient to meet the needs of users of the financial statements such that it is appropriate for the proposed standard to go beyond Section 10A requirements.

If the Board does not believe the Section 10A requirements are sufficient, we recommend discussions with the SEC and Congress to discuss the Board's views on the limitations of Section 10A. Without consistency in the requirements between Section 10A, and with the auditing standards requiring auditors to go beyond Section 10A, there will likely be confusion among auditors and users of the financial statements on the role of the auditor related to NOCLAR/illegal acts under Section 10A and the auditing standards.

Differences in Management's Requirements and Proposed Auditor Requirements

We believe that differences in requirements between the proposed auditing standard and existing securities laws related to the scope of laws and regulations to be considered in a company's financial reporting will lead to confusion among auditors and management teams on the scope of ICFR and put auditors in a position of performing the role of management in the area of NOCLAR.

The proposed standard incorporates new requirements in AS 2110.26 to obtain an understanding of management's processes and controls related to (i) identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements; (ii) preventing, identifying, investigating, evaluating, communicating, and remediating instances of noncompliance with laws and regulations; (iii) receiving and responding to tips and complaints from internal and external parties regarding noncompliance with laws and regulations; and (iv) evaluating potential accounting and disclosure implications of noncompliance with laws and regulations, including fraud. Management does not, however, have existing requirements in the federal securities laws that require them to obtain and retain the information that the auditor would be requesting to evaluate, leading to challenges in the auditor implementing these requirements in an effective and efficient manner.

Under US Securities and Exchange Commission (SEC) rules[3], the definition of internal control over financial reporting (ICFR) "does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements." It is not clear how the auditor would, for example, "obtain an understanding of management's processes and controls related to…preventing, identifying, investigating, evaluating, communicating, and remediating instances of noncompliance with laws and regulations…" when those controls are not within the scope of management's ICFR evaluation. There is a fundamental difference between the population of laws and regulations that management is required to consider for its ICFR evaluation and the population of laws and regulations that the auditor would need to evaluate (including management's related controls) pursuant to the proposed standard, which renders the proposed standard potentially inoperable without unreasonable cost and unintended consequences.

Differences in the Role of Management and the Independent Auditor and Potential Threats to Independence

We are concerned that some of the points made in support of the new standard are based on assumptions that conflate the role of management and the auditor. For example, the release states "Benefits, including for investors, likely would be greater for companies with weaker compliance

[3] See Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports https://www.sec.gov/rules/final/33-8238.htm

programs, which are in turn more likely to have undetected instances of noncompliance with laws and regulations, which auditors would in turn be more likely to detect by performing the enhanced procedures under the new standard. For companies with more developed and effective compliance programs, where the likelihood of material misstatement due to noncompliance with laws and regulations is lower, the benefit of the proposed standard would be lower." The first sentence cited above on the auditors' enhanced procedures does not use "material" for instances of noncompliance with laws and regulations. The second sentence that discusses the companies' compliance programs describes an effective compliance program as one "where the likelihood of material misstatement due to compliance with laws and regulations is lower." Without the reference to materiality, this language implies that the auditor is being directed to "fill the gap" for management by performing procedures on compliance. Such an assumption, however, risks putting the auditor, in effect, into the role of management by forcing the auditor to act as alternative management to act to prevent or early detect all possible violations of laws and regulations. That, however, is not, at least to this date, the role of the auditor, whose role instead is to audit and report on the financial statements in a manner that provides reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Within the benefits section under the economic impacts, the release states "earlier and enhanced identification, evaluation, and communication of information indicating noncompliance has or may have occurred should lead to more timely intervention by companies to cease and remedy noncompliance, lessen the impact of noncompliance, and thereby reduce the investor harm caused by legal and regulatory penalties as well as reputational loss." This language seems to imply that it is appropriate for the auditor to be the initial party to identify, evaluate and communicate information indicating noncompliance. The Board should continue to recognize that management is responsible for the preparation of its financial statements, including the identification of NOCLAR that has a direct and material effect on the financial statements. If the auditor is the primary party to identify, evaluate and communicate information regarding noncompliance, the auditor appears to be taking on the role of management in this area. Further, to the extent there is a view by the Board or others that a void exists with respect to companies' processes and procedures related to preventing, identifying, and disclosing NOCLAR, such that an assessment of the compliance programs of public companies would not meet the intended objective, filling such a void solely through the auditing standards will only create additional confusion on the role of the auditor with investors and other stakeholders.

In determining the possible effect of the likely noncompliance on the financial statements, the proposal implies, especially when considered in conjunction with the investor expectations outlined by the IAG Working Group in 2017, that there is an expectation for auditors to compel companies to make additional disclosures beyond what is required by generally accepted accounting principles related to NOCLAR. For example, there is a footnote reference to AS 2501 on proposed paragraph 16 of AS 2405 related to "the effect of the amounts and disclosures in the financial statements, including potential contingent monetary effects, such as fines, penalties, damages, or provisions for allowances or returns." If the auditor's evaluation of fair presentation is not grounded in the applicable financial reporting framework, the roles of management and the auditor may become obscured.

Currently, AS 2815.03 states, "The independent auditor's judgment concerning the 'fairness' of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles. *Without that framework, the auditor would have no uniform standard for judging the presentation of financial position, results of operations, and cash flows in financial statements*" (emphasis added). The auditor's judgment of the "fairness" of the presentation of the financial statements must be in the context of the applicable financial reporting framework.

If the auditor applies his or her own, unique perspective of what is necessary to achieve fair presentation, the auditor may be determining the presentation of the financial statements and identifying disclosures – in effect, the auditor may be preparing aspects of the financial reporting. In those instances, the auditor will not be able to apply impartial or objective judgments.

We believe the differences between management's and the auditor's responsibilities, as proposed, creates an increased risk of potential independence violations under existing SEC and PCAOB independence rules.

If the auditor is responsible for assessing and identifying potential instances of noncompliance in a law or regulation with which noncompliance could reasonably result in a material effect on the financial statements, which is beyond management's own requirements for assessing laws and regulations directly related to the preparation of financial statements, or the auditor is required to determine whether senior management has taken timely and appropriate remedial action to address noncompliance with laws and regulations that have a material effect on the financial statements, the auditor could be seen as "performing ongoing monitoring function for the audit client" under Rule 2-01. In addition, Rule 2-01 prohibits "providing any service to an audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided." When auditors are independently making determinations as to whether a potential instance of noncompliance is likely to have occurred, rather than understanding and assessing management's conclusions on such matters as an auditor would if there were a corresponding requirement of management, the auditor would appear to be performing unauthorized legal services for the company, which would be prohibited by the independence rules.

Within the release, there is discussion of the unintended consequence of the balance of work between the auditor and the company under audit, including between their respective specialists and discussion that companies "may lessen their own efforts." If companies lessen their own efforts, an additional unintended consequence of the proposal could be an increase in potential auditor independence issues, where the auditor is viewed as serving in the role of management in monitoring compliance with laws and regulations or providing legal services to the audit client.

Additionally, we believe there may be challenges in effectively executing the expanded inquires of the audit committee, management and others within the company about the risks of material misstatement, including fraud risk and NOCLAR. We agree that inquiries of relevant parties can be important procedures as part of the risk assessment process. However, our concern is that the required inquiries focus on "fraud risks and instances, or alleged or suspected instances, of fraud or other noncompliance with laws and regulations that could reasonably have a material effect on the financial statements." As the auditor's terminology and requirements are inconsistent with, and broader than, management's responsibilities in this area, we believe there may be challenges for the audit committee, management and others to be able to effectively respond to those questions. In order for individuals to effectively respond, processes (and controls) will need to be updated to extend the scope of management's assessment of laws and regulations to the definitions within proposed AS 2405.

Further, when the auditor's requirements are not aligned with management's responsibilities, there is an increased risk for an ineffective audit approach. As indicated in one of the Board's previous standard setting projects, PCAOB Rulemaking Docket Matter No. 38: *Auditing Standard on Related Parties and Related Amendments to PCAOB Auditing Standards,* the Board made updates to the final standard to address comments on a proposed requirement for the auditor to independently identify related parties. In the release, the Board stated, "In the Board's view, the clarifications in the reproposed standard represent a more effective audit approach that recognizes that the company is responsible for the preparation of its financial statements, including, in the first instance, the identification of the company's related parties, and <u>that the auditor begins the audit with information obtained from the company</u>." (emphasis added) Consistent with the previous project on related parties, the NOCLAR proposal is intended to heighten the auditor's attention in the area. We believe, similar to the Boards conclusions on related parties, the Board should focus on the alignment between requirements for auditors and management in the area of NOCLAR.

In summary, we believe it is important for there to be consistency in the scope of requirements related to NOCLAR and fundamental elements of the audit (such as the definition of internal control over financial reporting) with requirements within existing SEC rules and regulations and PCAOB auditing standards. We also believe that the proposed standard should continue to base the auditor's responsibilities for evaluating the fair presentation of the financial statements as is in the current applicable financial reporting framework, which is consistent with management's requirements. Further, the Board should not require the auditor to take on roles and responsibilities of management in the area of compliance or imply that the auditor could "fill the gap" for investors when management's compliance programs are weaker.

<u>Amendments to the Risk Assessment Standard to Address NOCLAR</u>

When AS 2110 was originally approved by the PCAOB in 2010, the release included the following content related to the current paragraph AS 2110.11:

> "*The auditor's decisions about whether to perform one or more of the additional procedures should be informed by whether the matters addressed in those procedures are important to the company's internal control or financial statements and whether such procedures are necessary to meet the overall requirements for obtaining an understanding of the company and performing risk assessment procedures."*

With the proposed amendments to procedures for obtaining an understanding of the nature of the company, the Board is moving from a risk-based approach, which has been stressed in past Board rulemaking projects, to a more prescriptive approach whereby auditors are "checking the box" with very prescriptive requirements. We are concerned that this will lead to a more ineffective audit as audit teams will evaluate information that may not be relevant for the audit of the company. This could result in auditors performing procedures where no risk is ultimately identified.

The Board is proposing amendments within AS 2110 related to reading publicly available information about the company. The updated list of sources of publicly available information the auditor should read includes public statements made or issued by the company's executive officers, including on the company's website or the company's or its executive officers' social media accounts, and media reporting. While we agree that it is important for the auditor to be aware of information being reported by the company and the company's executives, the standard lacks clarity around the extent of this new requirement and clarifications are needed to ensure the requirement is designed in a manner that results in the auditor obtaining and evaluating meaningful, useful information.

We agree with the Board that there is more publicly available information on companies through media reporting since AS 2110 was issued. Of course, not all of this information is reliable. However, with the explosion of media reporting and social media, we believe auditors will expend significant time and effort to identify the complete population of media reporting on the company and social media posts by the company. It would be particularly challenging, if not impossible, for auditors to assess the relevance and reliability of such media reporting, including determining how to consider and assess conflicting or purportedly "inaccurate" information. In addition, there may be multiple social media accounts linked to companies, including its divisions and subsidiary operations in various countries, that will have to be located and analyzed by the auditor. As a result, the auditor will spend considerable time and effort to evaluate the relevance and reliability of media reporting.

Although we agree that publicly available information is a source that can be used by auditors to identify and assess risks of material misstatement, including risks related to NOCLAR, we think the Board should design risk-based procedures around publicly-available information that recognize the level of reasonable assurance in performance of risk assessment procedures and, at a minimum, allow auditors to exercise due professional care and apply auditor judgment in determining the sources of information to be reviewed as part of AS 2110.11.

Ordering of Procedures with the Proposed Standard

From an audit process standpoint, proposed AS 2405 includes an evaluation of the potential effects of NOCLAR on the financial statements *after* the auditor has completed its procedures related to the identification and assessment of the risks related to NOCLAR. Overall, we believe this will lead to an ineffective audit approach, as auditors will perform the full complement of risk assessment procedures in AS 2405 and AS 2110 on potential NOCLAR where there may be no impact to the financial statements. Consistent with other areas of the audit, we believe auditors should plan and perform procedures when there is a risk of material misstatement to the financial statements.

We recommend that the Board include the determination of the possible effects of likely noncompliance on the financial statements as part of the risk assessment procedures, in order to eliminate situations where risk assessment procedures are performed to identify acts of noncompliance that has no material effect on the financial statements.

Areas Where Clarity is Needed

Interpretation of AS 2110.04

The release indicates that proposed amendments include an unconditional responsibility (that is, a "must") for auditors to plan and perform procedures to assess and respond to risks of material misstatement in the financial statements due to NOCLAR. This responsibility would be stronger than the presumptively mandatory (that is, a "should") general obligation to identify and assess risks of material misstatements in AS 2110.04.

We have concerns that this language seems to indicate that the auditor's responsibilities to assess and respond to the risks of material misstatement due to NOCLAR is greater than any other risk related to the financial statements. Although we acknowledge the importance of identification and assessment of the risk of material misstatement in the financial statements arising from NOCLAR, the use of "strong" language has the potential to take the auditor's attention away from focusing on the identification and assessment of other matters that have a material effect on the financial statements.

We suggest that the Board re-consider the terminology used in AS 2405 and AS 2110 to provide for consistent expectations in the area among auditors, management, audit committees as well as users of the financial statements.

Inclusion of Fraud

The Board has proposed to include fraud within the definition of NOCLAR. Within the release, the Board included the following footnote (emphasis added):

> Except as noted in Section IV, the term "fraud" used in this proposing release and its appendices has the same meaning as it does in paragraph .05 of AS 2401, *Consideration of Fraud in a Financial Statement Audit* (i.e., an intentional act that results in a material misstatement in financial statements that are the subject of an audit). To be clear, the definition of "noncompliance with laws and regulations" includes both fraud as defined under AS 2401.05 and all other types of fraud, such as non-scienter based fraud.

Throughout the remainder of the release, there is no other discussion of non-scienter based fraud or the Board's rationale for including non-scienter based fraud within the definition of NOCLAR. Based on the release, we are unable to determine whether the Board views the inclusion of non-scienter based fraud within the definition of NOCLAR as a change from the existing standards.

While we acknowledge the Board has a mid-term project related to fraud, we believe there will be confusion for auditors on what standards apply when the auditor identifies fraud or suspected fraud. In the release, the Board states "while AS 2401 would continue to govern the auditor's responsibilities with respect to the identification of information that may be indicative of fraud, the evaluation and communication of fraud would be addressed by proposed AS 2405, and those requirements would be applied in the same manner as for other forms of noncompliance with laws and regulations. In addition, we are proposing to combine the existing risk assessment requirements related to fraud with requirements related to other noncompliance with laws and regulations."

To provide transparency and clarity in the area of fraud, the definition of fraud should be consistent throughout the auditing standards. If the Board wants to include non-scienter based fraud, we recommend the term be defined in the auditing standards, and the Board include an explanation on the inclusion of non-scienter based fraud within NOCLAR and why the Board is proposing this change.

In addition, we believe that any changes to the area of fraud should be delayed and covered as part of the Board's mid-term project on fraud. Currently, we find the inclusion of the auditor's responsibilities related to fraud within different standards to be an area of potential confusion for auditors; this may create further confusion with investors and other stakeholders on the role of the auditor in the area of fraud.

Rescission of Auditing Interpretation (AI) 13

As part of the project, the Board is proposing to rescind AI 13, *Illegal Acts by Clients: Auditing Interpretation of AS 2405*. In the release, the Board says, "AI 13 provides that the internal controls provisions of the Foreign Corrupt Practices Act (FCPA) do not alter that auditor's responsibilities to consider a company's internal control over financial reporting in an audit of the company's financial statements." We agree with this statement, but a key aspect of AI 13 is that FCPA doesn't change the scope of internal control over financial reporting. AI 13 indicates not all internal control deficiencies identified by the auditor are noncompliance with the FCPA. AI 13 makes it clear there is a difference between internal accounting controls and internal control over financial reporting, which are both required under SEC rules and regulations. In the release, the Board cites confusion with respect to the proposed AS 2405 as reason for rescission of AI 13. However, we are concerned that the removal of AI 13 will only create additional questions on the difference between internal accounting controls and internal control over financial reporting and confusion of whether the SEC and PCAOB definitions of internal control over financial reporting are consistent.

If the Board still believes AI 13 should be rescinded, we recommend including additional discussion within other PCAOB auditing standards that explains the concepts and differences of internal accounting controls and internal control over financial reporting.

<u>Other Information</u>

Proposed AS 2405.09 requires that when an auditor determines that it is likely that noncompliance has occurred, the auditor must perform additional procedures to determine whether the likely noncompliance results in other information in documents containing audited financial statements, or the manner of its presentation, being materially inconsistent with information appearing in the financial statements or containing a material misstatement of facts. The existing requirements from AS 2710 state "the auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document."

In current practice, the disclosures in other information are evaluated against what management has disclosed within the audited financial statements. This approach seems appropriate for NOCLAR when noncompliance has a material effect on the financial statement amounts or disclosures. However, we are concerned the proposed requirement from AS 2405.09 is extending the auditor's responsibility to the other information. Specifically, in the release, there is language that indicates that when there is no material effect of NOCLAR on the financial statements, the auditor would be required to consider whether the other information was inconsistent with information in the audited financial statements. This seems to indicate there is a separate assessment for the impact of NOCLAR on other information, which would extend the auditor's responsibilities beyond the financial information identified in the audit report. If there is no material effect on the financial statements, it is not clear why there would be a requirement to evaluate the impact of NOCLAR on other information.

We suggest that the Board clarify that the auditor's responsibilities related to NOCLAR and other information are consistent with the existing requirements under AS 2710, and the proposed requirements within AS 2405 do not extend the auditor's responsibilities beyond the audited financial statements. Historically, when there is a need for discussion of other information, the Board has used cross references to AS 2710, instead of including procedures to address other information within the separate auditing standard. We believe this past practice should be applied here, in order to eliminate potential confusion and misunderstandings with investors and other users of the financial statements on the auditor's responsibilities related to other information.

<u>Investor Protection</u>

A high-quality audit ultimately benefits investors. As noted in the release accompanying the proposal, "The enhanced quality of audits and financial reporting should also increase investor confidence in financial statements." We take our PCAOB audit responsibility seriously. We are committed to the highest standards of audit quality to support the integrity of the capital markets and work to enhance audit quality.

As currently drafted, paragraph .01 of proposed AS 2405 is not sufficiently transparent about the auditor's role in investor protection. We recommend the Board refine paragraph .01 to reflect the role of the auditor in the capital markets more appropriately by implementing these revisions:

> Auditors have a fundamental obligation to ~~protect investors through the preparation and issuance of~~ <u>prepare and issue</u> informative, accurate, and independent auditor's reports <u>in accordance with the standards of the PCAOB. Those standards include</u> ~~and that obligation governs this standard to~~ identify<u>ing</u> and evaluate~~e~~<u>ing</u> ~~information indicating that~~ noncompliance with laws and regulations, including fraud<u>, that has a material effect on the financial statements</u> ~~has or may have occurred~~ and make appropriate communications to management and the audit committee about such information.

Investor protection includes many elements beyond the audit, and investors may have differing views on what should be done to protect their interests. Accurate financial reporting, high-quality audits, and effective regulation all play an important part in investor protection. While the auditor plays a role, other parties – such as management, the audit committee, and capital market regulators – are also vitally important to investor protection. As such, it is important that the auditing standards appropriately communicate the auditor's specific role.

<u>Communicating NOCLAR</u>

Within the economic analysis, there is a discussion that the proposed amendments would reduce information asymmetry between the auditor and audit committees. Based on our experiences, we don't believe information asymmetry currently exists between the auditor and audit committees in the area of NOCLAR. In practice, we observe active dialogue between the auditor, management teams, and the audit committee in the area, especially in light of the potential impacts to the company through penalties, fines or other material adverse consequences. In our experience, when matters come to the attention of the auditor (whether an act meets the definition of a direct act or indirect act), the auditor engages in discussions with both the management team and the audit committee on the matter, with a focus on the impact of the matter on the financial statements. The auditor is focused on the response from both parties to determine the impact on the audit of internal control over financial reporting as well as the substantive audit response to the matter. In these situations, we observe that audit committees are generally actively engaged to understand the views of both the auditor and the management team. If necessary, the audit committee will engage independent parties to assist in the evaluation of the matter.

These experiences demonstrate the importance of the roles of the auditor, management, and the audit committee in the area of noncompliance with laws and regulations; this reflects the shared responsibility that was envisioned with the passage of Sarbanes-Oxley.

We believe that the proposed requirement for the auditor to make an initial communication to management and the audit committee upon becoming aware that noncompliance "has or may have occurred", even in cases where the auditor has yet to determine whether noncompliance has or is likely to have occurred or if there are any associated financial statement impacts, will have a significant impact on the number of discussions with management and the volume of audit committee meetings (both formal and informal) that will need to occur. With the increased communication of instances of potential noncompliance and an earlier communication requirement, there could be additional costs for companies as audit committees may undertake more independent investigations, in response to the fear of potential litigation. Given the timing of these initial communications, it is likely a portion the investigations will ultimately determine noncompliance has not occurred or noncompliance has occurred but there is no material effect on the financial statements or disclosures. The investigations, along with increased reporting requirements, could result in auditors and audit committees focusing their attention on matters where there is no material effect on the financial statements or disclosures and away from matters that may have a material effect on the financial statements or disclosures.

The PCAOB should actively engage with audit committee members to understand current practices related to communication of NOCLAR with their auditors and their views on current best practices and areas where the communications could be improved. We know from past experiences that the staff from the PCAOB's Division of Registration and Inspections engages with audit committee members during the PCAOB's annual inspection process to discuss various topics. We encourage the Board to use this avenue to solicit input from parties that may be impacted by the proposed requirements in the area of communications. Additionally, the Board should consider whether there is an unintended consequence from the over-communication of potential matters with the audit committee and management. As more matters are communicated, the communications may become less relevant to management teams and audit committees, who may ultimately decide that they are not going to dedicate resources to investigate until there is determination by auditor on whether there is a material effect on the financial statements. This outcome would be inconsistent with the Board's view that "earlier communication would better enable management and the audit committee to be responsive, as necessary to such matters."

<u>Economic Analysis</u>

We believe there will be substantial costs to audit firms, issuers, broker-dealers and ultimately investors related to this proposal. Overall, we find the costs presented within the economic analysis to be significantly understated. There will be substantial costs to develop methodologies, training for auditors, and engaging specialists and lawyers to assist in this area. We believe there will be a need for firms to have a network of specialists and lawyers to both inform the firm centrally (e.g., National Office) and to assist audit teams in performing procedures in the area of NOCLAR. There will also be significant costs for issuers and broker-dealers, who will have to prepare additional information for the auditor. In addition, we believe the proposal will "impose" new requirements on issuers and broker-dealers related to noncompliance with laws and regulations that are currently not required under SEC rules and regulations. Management and audit committees may be required to engage additional resources (internal as well as external specialists and lawyers) to assist in the evaluation of the expanded list of laws and regulations. There will also be significant audit fee increases for audits related to issuers and broker-dealers for the time and effort to identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements. Although the release indicates that the Board would not require the auditor to identify all laws and regulations that the company is subject to, we believe it will be challenging for the auditor to identify laws and regulations with which noncompliance could <u>not</u> reasonably have a material effect on the financial statements.

We suggest that the Board update its economic analysis to appropriately reflect the substantial costs to audit firms, issuers, broker-dealers, and ultimately investors on this proposal. We are particularly concerned that the PCAOB is not appropriately considering the impact to issuers and broker-dealers by imposing “de facto” requirements on management through the auditing standards.

Further, the release does not contemplate or consider the increased risk to the company’s preservation of legal privilege, nor does it contemplate or consider whether a company would need to waive applicable privileges given the increased sharing of information between the company and the auditor, nor the consequences to the attorney client relationship of such required sharing of information. This increased sharing of information will, at a minimum, result in additional time and cost associated with navigating the privilege discussions and could subject the company to negative legal consequences.

Given the potential impact to issuers and broker-dealers and the number of significant projects on the Board’s standard-setting agenda, we believe the PCAOB should initiate a feedback mechanism (beyond the formal comment letter process) to solicit feedback from a range of issuers and broker-dealers on Board proposals. For example, the Board, in coordination with the SEC, should consider roundtables and target advisory groups that have significant representation of the issuer and broker-dealer community to provide a feedback mechanism.

<u>Effective Date</u>

The PCAOB’s proposal would require adoption of the amendments for audits of fiscal years beginning in the year after approval by the SEC (or for audits of fiscal years beginning two years after the year of SEC approval, if SEC approval occurs in the fourth quarter of a calendar year). As this could be as little as three months, we do not believe audit firms will have the ability to effectively and thoroughly implement the proposed AS 2405 and other proposed amendments within this compressed timeframe. Firms will need significant time to implement changes including updates to methodology, training of auditors, and the establishment of a network for specialists and legal counsel to both inform the firm centrally (e.g., National Office) as well as assist audit teams in performing procedures in the area of NOCLAR. This would likely be more challenging for audit firms with the Board’s other standard setting projects that may require adoption during the same time frame, including the new quality control standard, potential confirmations standard and the AS 1000 project. Given the potential impact of the proposal to companies and audit committees, these stakeholders will also likely require significant time and effort to further develop their processes and controls to address the expanded scope of NOCLAR. To allow sufficient time to implement the new standard thoroughly and thoughtfully, we encourage the PCAOB to allow for at least 24 months for implementation.

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We appreciate the opportunity to share our perspectives on the Board’s proposed auditing standard and proposed amendments. We would be pleased to discuss our comments with the Board or its staff. If you have any questions, please contact Matthew Schell or Kyle Owens.

Sincerely,

Crowe LLP

Crowe LLP