



D. Keith Bell
Senior Vice President
Accounting Policy

The Travelers Companies, Inc.
One Tower Square, 6PB A
Hartford, CT 06183

Phone: 860-277-0537

Email: d.keith.bell@travelers.com

August 7, 2023

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Proposing Release – *Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations* (PCAOB Release No. 2023-003, June 6, 2023: PCAOB Rulemaking Docket Matter No. 051)

Via: comments@pcaobus.org

Dear Ms. Brown:

The Travelers Companies, Inc. (“Travelers”) appreciates the opportunity to provide comments on PCAOB Release No. 2023-003, PCAOB Rulemaking Docket Matter No. 051 with the above captioned title (the “proposal”) as issued by the PCAOB on June 6, 2023.

Travelers provides a wide range of commercial and personal property and casualty insurance products and services to businesses, government units, associations, and individuals. A member of the S&P 500 and the Dow 30, Travelers is one of the oldest insurance organizations in the United States, dating back to 1853.

While we agree that the current auditing standard could be updated to recognize the growing complexity and risk of noncompliance with the laws and regulations to which a company is subject, the current proposal contains significant inconsistencies with existing audit guidance and introduces requirements for auditors that are far beyond a reasonable scope and expectations of an audit. It is our view that the proposal would result in significantly higher costs without an improvement in the assurance provided in the auditor’s opinion over the financial statements or management’s internal control over financial reporting. We believe there are more effective approaches that could be

incorporated in the PCAOB's auditing standards and suggest one such approach at the conclusion of our comments below.

We have significant concerns with several areas of the proposal, including the following:

1. The proposal changes the responsibility of the auditor from providing assurance to performing a management responsibility.
2. The proposal eliminates the distinction of noncompliance that has a direct versus indirect effect on a public company's financial statements.
3. The use of the terms "could reasonably have a material effect" in the proposal implies a lower level of likelihood than "substantial likelihood" as used in the definition of materiality in U.S. GAAP, which currently applies a "would reasonably influence" standard in determining materiality. Additionally, there is no definition of "could reasonably" or context provided in the proposal for how the terms would be applied.
4. The requirements that would be imposed on auditors in the proposal are completely disconnected from the control framework used by most companies in their internal control over financial reporting and the underlying accounting guidance for contingencies that may result from noncompliance, i.e., ASC Topic 450, *Contingencies*.
5. The proposal would significantly increase the auditor's responsibility from providing reasonable assurance over financial statements and management's internal control over financial reporting to a higher level of assurance, which is both inconsistent with other PCAOB guidance and, as a practical matter, not achievable.
6. The proposal likely would require the auditor to request information from companies that could result in the waiver of the attorney client privilege.

In addition to the above noted concerns, the proposal would require significant resources to implement without improving the assurance provided in the auditor's opinion over the financial statements or management's internal control over financial reporting. We believe that the additional costs associated with implementing this proposal will become part of the considerations made by companies when deciding whether to go public and could accelerate the trend of fewer companies deciding to go public.¹

¹ See *What Fewer Companies Means for You at: <https://kogod.american.edu/news/what-fewer-public-companies-means-for-you>*. Professor Ali Sanati, Kogod School of Business, American University, recent research regarding the decline of public companies in the United States from a peak of 8,090 in 1996 to 4,266 in 2019.

We address each of these points in further detail as discussed below:

1. The proposal changes the responsibility of the auditor from providing assurance to performing a management responsibility.

The current reporting framework that established management’s responsibility for preparing financial statements and the role of the auditor in providing reasonable assurance over the financial statements has been in place since, and is the result of the requirements contained in, the Securities Exchange Act of 1934 (the “Exchange Act”) was enacted. The proposal introduces significant ambiguities regarding management’s responsibilities versus the role of the auditor by requiring the auditor to perform a management function -- *to identify all laws and regulations with which noncompliance “could reasonably” have a material effect on the financial statements, to assess and respond to the risks of material misstatement based on the laws and regulations identified, and to determine whether instances of noncompliance have or may have occurred* -- rather than evaluate the effectiveness of management’s controls over compliance with laws and regulations.

In order to identify the laws and regulations with which noncompliance could reasonably have a material effect on financial statements, the auditor would first need to identify the entire population of laws and regulations applicable to the company. From this population, the auditor would then have to judgmentally determine, without legal training, which of the laws and regulations could reasonably have a material impact on the company’s financial statements. This is not only inconsistent with existing auditing standards but also is not a requirement imposed on a public company’s management under existing securities laws and their implementing regulations.

We believe that as part of management’s responsibility for the financial statements, a company should have implemented appropriate procedures and controls to identify the laws and regulations with which it must comply, along with an assessment of any related contingencies that should be recorded and/or disclosed. The auditor assesses the risk of a company’s noncompliance with laws and regulations and performs audit procedures to test the effectiveness of management’s controls. The auditor, however, should not be put in a position of performing management’s responsibilities, which in this case would require skills outside of the auditor’s current training. It is likely the proposal would result in auditors engaging outside experts or hiring legal expertise to perform the additional procedures. The proposal downplays this issue by stating that the auditor would “benefit from management’s process to identify certain laws and regulations” as it relates to certain disclosures made by the company, e.g., Regulation S-K disclosures regarding material risks. We note that while the auditor’s assurance does not currently extend to these types of disclosures, the proposal would effectively extend the auditor’s assurance on this disclosure by application of PCAOB Auditing Standard 1105.10 which requires the auditor to perform procedures to test the accuracy and completeness of the information.

Requiring the auditor to hire or employ legal consultants to perform this function would likely be costly, ineffective, and inefficient. There are many areas of highly specialized law and practice which would likely be involved and would require an insider's knowledge of the company's customer contracts, business processes, and legal and regulatory environment. This is particularly true for a highly regulated industry such as the property casualty insurance industry, which is governed by separate laws, regulations, and regulatory frameworks in each state. Additionally, as both a SEC registrant and an investor, we do not believe such a requirement would provide additional assurance.

2. As currently drafted, the proposal eliminates the distinction of noncompliance that has a direct versus indirect effect on a public company's financial statements.

The proposal inappropriately forsakes the distinction of direct versus indirect impact from illegal acts and moves to the idea of non-compliance with laws and regulations (NOCLAR) while imposing an unconditional obligation on the auditor to plan and perform the procedures discussed above.

When the auditor identifies or otherwise becomes aware of information indicating that noncompliance has or may have occurred (regardless of whether the effect is material to the financial statements), the auditor must evaluate the circumstances and communicate them to senior management and the audit committee, unless the matter is clearly inconsequential. Additionally, the proposal prescribes several actions the auditor must take to evaluate noncompliance and determine if it has occurred. If the auditor concludes that it is likely that noncompliance occurred, additional requirements come into play, including a determination as to whether senior management has taken timely and appropriate remedial action in response to the noncompliance.

By extending the auditor's responsibilities to include laws and regulations with which noncompliance could have an indirect impact on the financial statements, these requirements would extend the auditor's responsibilities well beyond providing reasonable assurance that a company's financial statements were prepared in accordance with U.S. GAAP and regarding the effectiveness of the company's internal control over financial reporting (ICFR). Moreover, the effort to extend the auditor's responsibility beyond the financial statements and management's ICFR exceeds the authority granted under Section 10A(a) of the Exchange Act without a clearly identified rationale related to the quality of the financial statements, i.e., identifying when non-compliance can have a direct impact on the financial statements.

3. The use of the terms "could reasonably have a material effect" in the proposal implies a lower level of likelihood than "substantial likelihood" as used in the definition of materiality in U.S. GAAP, which currently applies a "would reasonably influence" standard in determining materiality. Additionally, there is no definition of "could reasonably" or context provided in the proposal for how the terms would be applied.

The proposal uses the terms “could reasonably have a material effect” on financial statements but provides no definition or context for which the terms “could reasonably” would be applied. Moreover, the use of the terms “could reasonably” in the proposal is at odds with the concept of materiality that is contained in the ruling by the U.S. Supreme Court in *TSC Industries v. Northway, Inc.*² The Supreme Court opinion in this case ruled “that a fact is material if there is a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available” (emphasis added). bThis ruling is the basis for the definition of materiality in U.S. GAAP, including the guidance issued by the SEC regarding materiality.

As currently drafted, the use of the terms “could reasonably” implies a lower level of likelihood than “substantial likelihood” as used in the definition of materiality in U.S. GAAP³, which currently applies a “would reasonably influence” standard in determining materiality. Under U.S. GAAP guidance, a fact is material “if there is a substantial likelihood that a reasonable shareholder would consider it important”. We believe applying a different standard for assessing materiality for PCAOB purposes would not only cause confusion but would also result in uneven interpretation and application by auditors and others. The terms “could reasonably” is overly broad, would be extremely difficult to implement, and could lead to divergence in practice by auditors. In addition, this apparent broadening of the principle of materiality will likely increase the costs, delays, and other unintended negative consequences of the proposal described elsewhere herein.

4. The requirements that would be imposed on auditors in the proposal are completely disconnected from the control framework used by most companies in their internal control over financial reporting and the underlying accounting guidance on which any contingencies resulting from noncompliance is based, i.e., ASC Topic 450, *Contingencies*.

The majority of public companies have adopted the Internal Control – Integrated Framework (the Framework), published by the Committee of Sponsoring Organizations of the Treadway Commission (the “COSO framework”). The 2013 COSO Framework introduced Principle 8: the organization considers the potential for fraud in assessing risks to the achievement of objectives. The concept of a fraud risk assessment (“FRA”) is to enable management to identify the “who, what, where, and how” of potential fraud schemes that may impact their company. FRAs assist management in identifying and addressing potential gaps in their internal control framework that could indicate an increased likelihood of fraud by identifying fraud risk factors, such as an increased pressure to meet earnings targets. Management evaluates its existing internal controls framework to determine the residual risk score for various types of fraud, which can

² See *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 439 (1976) as cited in *SEC Staff Accounting Bulletin No. 99 (SAB 99)* (August 12, 1999).

³ See *FASB Concept 8, Conceptual Framework for Financial Reporting*. Concept 8 initially changed the determination of materiality from “would” influence to “could” influence and was amended in 2018 to align with the Supreme Court definition reverting back to “would” influence.

include noncompliance with laws and regulations.

We note that AS 1001: *Responsibilities and Functions of the Independent Auditor*, AS 2201: *An Audit of Internal Control Over Financial Reporting that Is Integrated with an Audit of Financial Statements*, and AS 2401: *Consideration of Fraud in a Financial Statement Audit* require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. This guidance establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements. Additionally, AS 2405: *Illegal Acts by Clients*, requires the auditor to perform procedures including: reading minutes; inquiring of the client's management and legal counsel concerning litigation, claims, and assessments; and performing substantive tests of details of transactions or balances. This guidance also includes making inquiries of management and the audit committee concerning the client's compliance with laws and regulations and knowledge of violations or possible violations of laws or regulations and:

- The client's policies relative to the prevention of illegal acts.
- The use of directives issued by the client and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations.

It appears that none of the above referenced auditing standards have been updated to reflect or acknowledge the changes that were included in Principle 8 of the 2013 COSO Framework. As described under Alternative Approach below, we would expect updated audit procedures to include identification and testing of controls put in place by management as part of its implementation of Principle 8 of the COSO Framework.

Additionally, the proposal not only diverges significantly from other current PCAOB auditing guidance, including AS 2405: *Illegal Acts by Clients*, but is also completely disconnected from the underlying accounting guidance on which the accounting for and disclosure of, any losses, fines, penalties, etc. that may result from noncompliance with laws and regulations is based, i.e., ASC Topic 450, *Contingencies*.

Instead of addressing the auditor's responsibility in evaluating the effectiveness of a company's internal controls over the reporting of an accrual or disclosure resulting from noncompliance with laws and regulations, the proposal would require auditors or their specialists to replicate management's efforts (at a level that is not likely to be at the same depth as management's) to obtain evidentiary matter, review internal documentation and communications, conduct legal research, and interview management. This approach significantly expands the current scope of the auditor's responsibilities and goes well beyond both the training and skill sets of auditors, as well as the confines of the auditor's opinion over a company's financial statements and ICFR. This approach treads very close to impairing the auditor's independence. We believe that imposing these responsibilities on auditors creates a high risk of misleading investors that the auditor has provided a greater level of assurance, implies that the auditor has a shared responsibility in the preparation of the financial statements, and significantly increases the cost, and risk of delay, of an audit due to the additional audit procedures that would need to be applied and the additional liability that the auditor will incur when litigation regarding losses, fines,

and/or penalties occur from issues that were not identified by the auditor during the course of an audit.

5. The proposal would significantly increase the auditor’s responsibility from providing reasonable assurance over financial statements and management’s control over financial reporting to a higher level of assurance, which is both inconsistent with other PCAOB guidance and, as a practical matter, not achievable.

As currently drafted, the proposal would clearly impose additional responsibilities on the auditor and implies, as noted above, a level of assurance greater than reasonable assurance. This point is further emphasized as a result of the following guidance from AS 2401 being excluded from the revised AS 2405:

However, absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud. A material misstatement may not be detected because of the nature of audit evidence or because the characteristics of fraud as discussed above may cause the auditor to rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent. Furthermore, audit procedures that are effective for detecting an error may be ineffective for detecting fraud.

Consistent with our prior comments regarding the use of the terms “could reasonably”, the omission of the above guidance regarding absolute assurance implies that the auditor has moved from providing reasonable assurance to something closer to absolute assurance. We believe that imposing these responsibilities on auditors creates a high risk of misleading investors that the auditor has provided a greater level of assurance than what is actually performed and significantly increases the cost, and risk of delay, of an audit due to the additional audit procedures that would need to be applied and the additional liability that the auditor will incur when litigation losses, fines, and/or penalties occur from issues that were not identified by the auditor during the course of an audit.

6. The proposal likely would require the auditor to request information from companies that could result in the waiver of the attorney-client privilege.

As noted above, the proposal would require the auditor to “identify whether there is information indicating noncompliance with those laws and regulations has or may have occurred.” This likely would require the auditor to request information and legal analyses from companies to help the auditor make its assessment. Responding to such a request could result in the waiver by such companies of the attorney-client privilege.

The existing approach, which was developed with the American Bar Association, avoids this result while still facilitating the sharing of information with auditors that is necessary to complete the audit. This balanced, long-standing approach, which includes relying on representations from outside counsel, has served companies, auditors, and investors well over a long period of time. The proposal, however, threatens this balance. We are concerned that if the proposal results in

companies being forced to waive legal privilege to complete an audit, the results could be very harmful given the highly litigious state of the legal system that we currently operate in.

Alternative Approach

We believe a more effective and efficient approach to auditing a company's risk of noncompliance with laws and regulations is to design the audit procedures around an evaluation of a company's fraud risk assessment as described in Principle 8 of the 2013 COSO Framework and the identification and testing of the company's internal controls related to compliance with laws and regulations. The audit procedures should be based on a risk-focused approach and consistent with how other risk areas are evaluated and tested during an audit. More importantly, such an approach should not involve the auditor duplicating management's efforts but should be designed with the goal of determining whether internal controls effectively prevent or discover material misstatements at the appropriate assertion level using the foundational testing approaches described in AS 13: The Auditor's Responses to the Risks of Material Misstatement:

- *Inquiry,*
- *Observation,*
- *Examination or inspection of evidence,*
- *Re-performance of the control, and*
- *Computer-assisted audit technique (CAAT).*

* * *

We thank you for the opportunity to comment on the proposal and would be pleased to discuss our views with the PCAOB in any forum the PCAOB may choose. If you have any questions or would like to discuss our comments, please feel free to call me at (860) 277-0537.

Sincerely,

