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

Re: PCAOB Rulemaking Docket Matter No. 051

Dear Office of the Secretary:

The National Association of Corporate Directors (NACD) is pleased to comment on the recent rulemaking release from the Public Company Accounting Oversight Board (PCAOB or Board), *Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations*, PCAOB Rel. No. 2023-003 (Proposal).

As the nation's leading organization for director education and certification, with a membership of more than 23,000 board members, many of whom are audit committee members and chairs, NACD is well aware of the importance of financial statement audits and of the role of the independent audit committee in engaging and overseeing the auditor and the audit engagement, as well as the processes companies have in place to detect and address noncompliance with laws and regulations. In view of the importance of the director constituency it serves, NACD is providing its comments to the Board on the Proposal and the effects it will likely have on the oversight of the current structure and scope of audits and company compliance programs, as well as the role of boards and audit committees in their oversight of compliance.

Based on our conversations with multiple audit committee leaders over many years and in recent days,[1] NACD can attest that this sweeping and unprecedented Proposal raises significant areas of concern for public companies and their directors, particularly those serving on audit committees. Indeed, the Proposal uses the term "audit committee" approximately 140 times, clearly illustrating the substantial impacts that the Proposal will have on an audit committee's duties and responsibilities.

[1] Following the publication of the Proposal and in preparing this comment letter, officers of NACD solicited the views of several audit committee leaders representing a wide range of companies and industries.

Overview

If adopted as proposed, the Proposal would drastically change the current model for the work of the auditor, the audit committee, and management, increasing costs without commensurate benefits. We have six key areas of concern—namely, that the Proposal

- transforms the financial statement audit into a compliance audit;
- impacts company directors and audit committees;
- erodes legal privilege;
- requires the auditor to conduct inquiry and other audit steps with respect to substantive subject matters that are clearly outside of its education, training, experience and expertise;
- necessitates an expanded internal control framework and additional controls and procedures; and
- lacks sufficient cost-benefit analysis.

Under the expanded standard in the Proposal, the auditor would effectively no longer be performing a financial statement audit but rather an audit of a company's compliance function. In being assigned the duty of auditing for noncompliance with laws and regulations, an auditor would effectively be making legal judgments, raising issues not only of auditor qualifications and competency but also of preserving the company's legal privilege. Further, these expanded duties and obligations would likely distract the auditor from focusing on material audit and financial accounting issues, thereby potentially and adversely impacting a company's ability to meet its periodic report filing deadlines and disrupting the timely flow of financial data to investors.

The Proposal does not articulate any pressing issue or problem or investor protection concern that necessitates such a sweeping change at this time. Instead, the Proposal cites to the general observation that "[i]n recent years, highly publicized matters" have "resulted in penalties, fines, damages, or other material adverse consequences to the company and harm to investors" as a result of "failures to comply with the applicable laws and regulations." Board Chair Erica Y. Williams expanded on this point in her *Statement on Proposed New Standard Regarding Noncompliance with Laws and Regulations*: "When sanctions, fines, and civil settlements directly affect a company's bottom line, or reputational damage causes a company's stock value to decline, innocent investors pay a price." As an example of this, Chair Williams cited to Wells Fargo's $1 billion settlement in May 2023 to settle a class-action lawsuit regarding allegations that Wells Fargo "made misleading statements about compliance with consent orders imposed by federal regulations," which statements, incidentally, have nothing to do with a financial statement audit or even the type of compliance audit that the Proposal contemplates.

While we recognize that, from time to time, there are instances of noncompliance that make headlines and result in large fines, we do not believe these instances—which are not limited to "recent years" and, in any event, are not novel in any respect—support or justify a drastic transformation of the nature of the financial statement audit or the role of the auditor. Indeed, existing accounting principles already timely address the impacts of noncompliance through the accounting standard for loss contingencies. The Proposal does not assert that the Board believes GAAP's loss contingency provision is not working effectively in timely informing investors about possible losses.

Furthermore, the Proposal does not acknowledge the progress than companies have made in reducing their exposure to noncompliance risk over the past 20 years. Since the creation of the PCAOB and the enactment of the Sarbanes-Oxley Act in 2002, companies have expended significant resources into developing and improving their compliance programs, including enhancing the role of internal audit, anti-fraud policies, and internal controls. In our view, the existing regulatory frameworks and internal control systems are robust and provide substantial protections for investors, as intended and required by the Sarbanes-Oxley Act. In the absence of a more defined and substantiated concern, we do not believe that the extensive new requirements contained in the Proposal have been sufficiently justified.

In the same way that the Proposal does not adequately specify the benefits it will impart, it also does not take into account the full spectrum of costs auditors and companies will be forced to incur to comply with the new standard. For example, companies will likely need to incur costs to expand existing compliance systems to encompass all laws and regulations to which they are subject, as well as dedicate additional time and effort to oversight of those new and expanded compliance programs. Audit committees, too, will need to take on additional responsibilities to oversee the additional auditor obligations created by the Proposal. From the perspective of audit committee members and board members for a diverse array of public, private, and nonprofit organizations, we are concerned about the ability of companies to operationalize the expanded compliance systems and controls necessary to respond to the expanded audit scope, and about the ability of audit committees to oversee audits with such expanded scope while also contending with the expanded sets of communications contemplated by the Proposal.

As Board Member Duane M. DesParte noted in his dissent to the Proposal, *Statement on Proposal to Amend PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments*:

> "Stepping back, this project is one of 14 on our ambitious standard-setting agenda. Each of the projects is significant. As we proceed one-by-one, I am increasingly concerned we are establishing new auditor obligations and incrementally imposing new auditor responsibilities in ways that will significantly expand the scope and cost of audits, and fundamentally alter the role of auditors without a full and transparent vetting of the implications, including a comprehensive understanding of the overall cost-benefit ramifications."

We share Board Member DesParte's concerns and the need to view the Proposal holistically alongside the dozen others the PCAOB has been publishing in rapid fashion along with the SEC's expanded rulemaking agenda (e.g., in cybersecurity and in climate change). This expanded scope of considerations for audit committees and management, and the related burdens and resources required to meet this expanding regulatory agenda and the related increases on the costs of doing business, should be considered in total—not in a vacuum. These considerations do not appear to have been taken into account by the Proposal.

Expansion of the Financial Statement Audit into a Compliance Audit

Under current standards, an audit is designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the financial statements. Under the Proposal, the financial statement audit would expand into a compliance audit. As a starting point, paragraph .04 of the Proposal requires the auditor to identify all laws and regulations with which "noncompliance could reasonably have a material effect on the financial statements." Although the Proposal states that this requirement is "appropriately tailor[ed]" and would not "represent every law or regulation to which the company is subject," the opposite is true. In order to meet this standard, it is foreseeable that the auditor would indeed feel obligated to require its clients to inventory every single law and regulation to which they are subject worldwide, including all local, state, federal, and foreign laws and regulations, before then determining whether instances of hypothetical "noncompliance" with any single law or regulation "could reasonably have a material effect on the financial statements." Bearing in mind that the proposal leaves these key terms undefined, this baseline inventory of laws and regulations would take inordinate effort, resources, and expertise that are well beyond the reasonable steps that public companies—even Fortune 500 companies with strong compliance programs—currently undertake to achieve compliance with securities laws and other frameworks that establish the basis of a company's compliance programs.

Once the auditor has finished identifying all applicable laws and regulations, the auditor would then have to take the results of that inventory and assess whether "noncompliance" with any of those laws and regulations "could reasonably have a material effect on the financial statements." Complicating that effort is that, in general, the Proposal does not adequately define or even understand the key term "noncompliance." Appendix A of the Proposal defines "noncompliance with laws and regulations" as "an act or omission, intentional or unintentional . . . that violates any law or any rule or regulation having the force of law." In our view, the auditor will not be able to identify "the laws and regulations with which noncompliance could reasonably have a material effect on the financial statements" without making an assumption about the extent or degree of compliance. Yet the Proposal provides no guidance as to how these assumptions should be developed. A driver operating her car at 58 miles per hour when the speed limit is 55 miles per hour is not in the same position of risk of penalty—i.e., getting pulled over by the police and fined—as a driver operating her car at 95 miles per hour. The same holds true of most, if not all, laws and regulations, including those that have strict liability. The risk or likelihood of enforcement or liability, and the amount of penalty, is and should be greater when the extent or degree of noncompliance is greater.

In addition, the Proposal further does not provide a framework for determining what "could reasonably have a material effect" means in practice. Among other things, it is not clear if the determination would mean the auditor (and, effectively, management) is supposed to assess those laws and regulations that could reasonably have a material effect on the financial statements if there is noncompliance as of the current moment in time (or as of the filing date of the annual report on Form 10-K) or could reasonably have a material effect on the financial statements at some indeterminate time in the future. This aspect of the Proposal alone is deeply troubling to conscientious audit committee members and indeed all directors, as it would inevitably give rise to speculation about uncertain and unknowable future events that only would be judged in hindsight.

After this step of identifying likely noncompliance (as noted, above, undefined in degree), the Proposal then would require the auditor to develop audit steps to identify potential noncompliance with respect to those laws and regulations that "could reasonably have a material effect" on the financial statements. Although companies already have robust compliance programs in place, it is foreseeable that additional programs would have to be put into place in areas where the auditor says there could reasonably be a material issue. This would be an odd role for the external auditor to play and could complicate the auditor-client relationship—because identifying where to implement compliance systems is traditionally the role of management and the board. This, too, would add substantial additional costs for companies and consume extensive time of management and audit committees.

As part of developing its audit steps, an auditor under the Proposal must see if it can identify any noncompliance, not only through management inquiry but also through other audit steps that appear to call for more investigatory-type procedures—steps which in turn would require audit committee oversight. This part of the Proposal—which seems to contradict long-established judicial standards for compliance oversight[2]—fails to acknowledge what this exercise would entail. The Proposal assumes that laws and regulations are clear bright line rules for which there is widespread and easily understood agreement as to what those rules mean—and that determining whether there is any noncompliance with such laws and regulations is a check-the-box exercise that can be done for each and every one of the thousands of laws and regulations that can apply to a public company within the time period of the annual audit. However, the application of law to facts can be highly complex and requires legal judgment and experience; many laws are expressed as standards and their applicability to any particular fact pattern requires reasoned and experienced interpretation and even regulatory expertise. Oftentimes, whether any particular fact pattern indicates that there is noncompliance with a law or regulation is not resolved without months or even years of investigation by teams of lawyers and even, in some cases, adjudication. Yet, the Proposal seems not to acknowledge any of these nuances and significant uncertainties.

After applying these audit steps, the auditor would have to assess the potential impact on the financial statements and management's response to any identified noncompliance and then engage in new and more extensive series of communications with the audit committee about any identified noncompliance. Specifically, the auditor would be required to communicate to the audit committee about matters involving noncompliance with laws and regulations, *even if* such noncompliance is perceived *not* to be material to the financial statements. The only matters that are spared the requirement of discussion with the audit committee are

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[2] See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) ("In notably colorful terms, the court stated that 'absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.'" (quoting *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963))).

those that are "clearly inconsequential"—far too low a standard to be meaningful in practice. In addition, in practice, the auditor is unlikely to feel comfortable in reaching this conclusion because of incomplete factual development. Although the Proposal notes that the auditor does not have to duplicate communications about noncompliance that management has made, the Proposal would nonetheless oblige the auditor to understand and evaluate those management communications, and to communicate to the audit committee any areas it identifies where management's communication is viewed by the auditor as being incomplete or inadequate.

Impact on Company Directors and Audit Committees

In creating these additional auditor and audit committee obligations, the Proposal does not acknowledge what boards, audit committees, and internal audit and compliance already do. Nor does the Proposal adequately evaluate the impact it will have on the work of directors, particularly those serving on audit committees.

Boards, through their audit committees, generally have oversight responsibilities with respect to a company's compliance with laws and regulations. Audit committees spend significant time throughout the course of a year understanding the scope and nature of company compliance programs, overseeing management's conduct of compliance programs, as well as addressing instances of noncompliance identified under such compliance programs and otherwise, such as whistleblower channels of communication.[3] In this context, audit committees are very well versed in the steps that auditors take to evaluate noncompliance in the context of Section 10A of the Securities Exchange Act of 1934 and existing AS 2405, *Illegal Acts by Clients*. Furthermore, although the Proposal notes that auditors may seek to rely on the work done by the company's internal audit function, the Proposal does not acknowledge the significant role internal audit plays in a company's compliance and internal controls system. As the PCAOB has recognized elsewhere, "An important responsibility of the internal audit function is to monitor the performance of an entity's controls," including through procedures assessing "the design and effectiveness of controls that pertain to the entity's ability to initiate, record, process, and report financial data consistent with the assertions embodied in the financial statements or that provide direct evidence about potential misstatements of such data."—AS 2605, *Consideration of the Internal Audit Function*.

[3] Incidentally, research shows that the vast majority of reported noncompliance allegations do not relate to accounting, audit and financial reporting issues. For example, according to Navex's *2023 Risk & Compliance, Hotline & Incident Management, Benchmark Report*, there were 1.52 million whistleblower reports in 2022 (across 3,430 organizations), with only 2.12% of complaints related to accounting, auditing and financial reporting issues. When investigated, less than half (41%) of all whistleblower complaints were substantiated either in whole or in part.

Clearly, audit committees are already tasked with the responsibility of overseeing a company's compliance programs and internal controls, with the assistance of internal audit, yet the Proposal would necessarily lead to significant expansion of an audit committee's responsibilities because the scope of the audit engagement would correspondingly have been significantly expanded. In addition, the extensive new communication requirements—triggered even where instances of noncompliance are not perceived to be material—would burden audit committees and their agendas and distract from matters that are more fundamental to financial reporting and related disclosures.

We also are concerned that the Proposal would adversely alter the dynamic of the relationship between the audit committee and auditor. The audit committee would likely be placed in the role of serving as arbiter between management and auditor in numerous new and concerning situations. For example, as noted above, the Proposal would require the auditor to exercise what amounts to legal judgments in order to fulfill the objectives of the Proposal, including "determining" whether noncompliance with laws and regulations has occurred. In so doing, the Proposal creates the potential of conflicting views of legal compliance as between the company's counsel and the independent auditor (including those of any legal advisor whom the auditor engages).

This dynamic would not be productive and would be exacerbated by the fact that the audit committee inevitably would have to navigate and resolve these differing, even disparate, views about legal judgments and conclusions—a responsibility which the audit committee itself may not be positioned to perform. (After all, the definition of "audit committee financial expert" in Regulation S-K Item 407(d)(5)(ii) says nothing about legal training or experience.) This could give rise to a need for separate legal counsel to the audit committee, which may need to perform yet another investigation to come to a final determination with respect to a noncompliance issue. Especially for global companies, which may need to comply with foreign laws that may not be aligned, or may even directly contradict, US laws, the need for the audit committee to bring in separate counsel could foreseeably become a daily cost of doing business. This would add yet another new cost to the list of those associated with the Proposal, which are discussed in further detail below.

Potential Erosion of Legal Privilege/Lack of Auditor Competence/Loss of Independence

The Proposal threatens the erosion of the company's legal privilege. Paragraph .07 requires the auditor to "determine whether it is likely that" any potential noncompliance identified actually occurred. However, as noted earlier, auditors generally do not have the ability or competence to make such a determination, which would require legal expertise, judgment, and experience. Legal judgments would need to be brought to bear in order to identify and determine if noncompliance has occurred. Yet the Proposal simply notes that the auditor will likely need to engage legal specialists or lawyers to identify and evaluate noncompliance. It does not grapple with the myriad of issues that arise by placing the responsibility on the auditor to "determine" those legal judgments.

As reflected by the limitations in the existing standards, the area of legal judgment has historically been viewed as outside the scope of audits and outside the competencies of an auditor. For example, AS 2405.03 currently states, "[T]he determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law." The Proposal would leave this familiar realm behind and instead thrust the auditor into making non-expert judgments on frequently complex legal matters, many of which are imbued with inherent uncertainties, such as complex legal judgments about future prospects of how any given matter of noncompliance may play out following regulatory investigations, litigation, and appeals. Acknowledging that the auditor may be able to or may even need to hire legal advisors does not adequately address the competency issue: ultimately, it is the auditor, and not its legal advisor, who signs the audit opinion and has liability for its audit under the federal securities laws.

The Proposal also fails to discuss how to deal with defenses (and the merits of defenses) to alleged noncompliance and the levels of violations and potential penalties, which, for example, may turn on intent or negligence, or a regulator's evaluation of the company's cooperation or history of past noncompliance. Nor does the Proposal acknowledge how the auditor is expected to make those judgments in what inevitably will be compressed time frames to meet the Form 10-K reporting deadlines, as opposed to in an open-ended regulatory investigation context.

Among the more notable omissions in terms of complications are these: the Proposal fails to address how the exchange of information on matters of noncompliance between the auditor and management could occur and still afford appropriate respect to the company's applicable and valid legal protections, including the attorney-client privilege. The Proposal mentions attorney-client privilege only *once* in 146 pages; the phrase is not even included in the actual proposed audit standard that is included as Appendix 1 of the Proposal. The Proposal does not address how its expanded requirements could lead the auditor to press the company for disclosure of otherwise privileged attorney-client communications so that the auditor can evaluate and assess potential noncompliance and remediation.

Many large companies employ hundreds or even thousands of attorneys, both internal and external, to perform investigations of potential noncompliance and respond to regulators. If the Proposal is adopted as proposed, the auditor may interpret the requirements to mean that they would need to access these reports—resulting in the auditor treading into heretofore unexplored territory when it comes to the preservation of legal privilege. The Proposal is silent on the substantial costs to public companies that could arise if these legal protections are lost.

The proposed requirements could also lead to a determination that the auditor, now a de facto consultant to management opining on issues unrelated to a financial audit, could lose its independence. Furthermore, some audit firms may be unable or unwilling to take on this kind of work, further reducing the already diminishing pool of auditors with the experience, expertise, and staff to audit large, complex companies.

Expanded Internal Control Framework

Another unacknowledged risk of the Proposal comes in the form of the potential need for companies to expand their frameworks for internal control over financial reporting (ICFR). There is currently no requirement for management to inventory and assess noncompliance with all applicable laws and regulations, including local, state, federal, and at the international level. The SEC's rules regarding ICFR only encompass laws and regulations directly related to the preparation of financial statements, as opposed to all applicable laws and regulations. However, the Proposal would require the auditor to evaluate *any* law or regulation subject to potential noncompliance that could have a material impact on the financial statements. This could lead to a situation where the auditor believes the standard requires them to understand the controls a company has in place to evaluate which laws and regulations it is subject to and, for those where there could reasonably be a material impact, what controls the company has in place to develop, monitor, enhance, and update its compliance program in that area.

For example, under the Proposal, in order for the auditor to assess noncompliance with applicable laws and regulations, and, as required by paragraph .11, "whether senior management has taken timely and appropriate remedial action with respect to" any identified noncompliance, an issuer's internal controls may have to be expanded to include aspects of compliance programs (monitoring, identification of issues, remediation, etc.). Therefore, given the work the auditor would have to do to identify and assess noncompliance under the proposed standard, we are concerned that the Proposal implicitly could lead to an expanded set of internal controls over financial reporting. Expansion of ICFR systems to comply with the requirements of the Proposal could require companies to bear significantly higher costs, which are not addressed in the Proposal's cost-benefit analysis.

Lack of Sufficient Cost-Benefit Analysis

The PCAOB's mission is to "regulate[] the audits of public companies and SEC-registered brokers and dealers in order to *protect investors* and *further the public interest* in the preparation of informative, accurate, and independent audit reports."[4] We have significant concerns that this Proposal risks going in the opposite direction. As outlined above, this wide-ranging and vague new proposed audit standard portends substantial new costs for public companies and burdens for audit committees without any demonstrated commensurate benefits for investors. Public companies likely will need to incur costs and expand their compliance programs to include all laws and regulations to which they are subject and which are identified as areas that could reasonably have a material effect on the financial statements. Directors, principally those serving on audit committees, will need to dedicate substantial additional time and effort to oversight of expanded and new compliance programs. We also are concerned that aspects of the Proposal could make it more challenging for public companies to meet their annual report filing deadlines given the additional work required of auditors and management, all of which could negatively impact investors.

The costs of audits will also increase, perhaps substantially both because of the expansive new steps the auditor would have to take and because of the additional legal resources that the auditor may have to engage in the relevant legal areas for a company's applicable set of laws and regulations. Following the enactment of the Sarbanes-Oxley Act, total audit fees were estimated to have increased by nearly 60 percent from fiscal year 2003 to fiscal year 2004. According to at least one source,, total audit fees for fiscal year 2021 were approximately $15.5 billion, or approximately $2.2 million per company on average.[5] If the Proposal has the same impact on audit scope as Sarbanes-Oxley did—which is not unrealistic given the breadth and expansion of the auditor responsibilities contemplated by the

[4] *Mission, Vision, and Values*, PCAOB, https://pcaobus.org/about/mission-vision-values (emphasis added).

[5] Audit Analytics Report, "Twenty Year Review of Audit and Non-Audit Fee Trends," https://blog.auditanalytics.com/twenty-year-review-of-audit-non-audit-fee-trends-report/

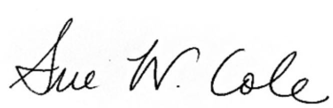
Proposal—it is possible that total audit fees could increase by a commensurate percentage, or to almost $25 billion (almost $3.5 million per company on average).[6]

In stark comparison, the Proposal provides little to no support for the notion that the Proposal would benefit investors, and certainly does not provide the support necessary to justify such a drastic expansion of audit standards. The Proposal provides *no basis* for concluding that it would result in higher levels of public company compliance with laws and regulations. In short, the cost-benefit assessment undertaken for the Proposal is substantially lacking. As it stands, particularly in view of the significant costs it would impose on public companies, the Proposal is likely to be challenged in court. We therefore urge the Board to reconsider the Proposal in its entirety. At the very least, the Proposal requires significant additional cost-benefit analysis and a more thoughtful appraisal of how it will change the status quo before it can seriously be considered.

Conclusion

In our view, the current standards strike the right balance in allowing the auditor to evaluate effects of potential loss contingencies on the financial statements without layering on undue and unjustified procedures that harm company performance and, ultimately, investors. In order to fulfill its mission to protect investors and further the public interest, the Board should not proceed with the Proposal.

Sincerely,



Sue Cole, Chair

Peter R. Gleason, President and CEO

National Association of Corporate Directors

[6] Ibid, with additional calculation by NACD Staff.