

Rulemaking Docket Matter No. 051

Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments

August 7, 2023

I like what the PCAOB is trying to do with respect to NOCLAR, but I cannot support the proposal as currently formulated given the absence of a quantitative cost-benefit analysis. The PCAOB proposal has the possibility for both great benefit and great cost; hence the importance of a suitable cost-benefit analysis. A detailed cost-benefit analysis would also provide greater clarity as to the contemplated scope of effort and the potential benefit. Although it is the public companies that would bear the cost, the PCAOB's mindset should be "to evaluate the cost of the proposal as if it was the PCAOB's money that was being spent."

The estimation of cost within a broad range can be accomplished by developing a representative profile of hypothetical companies reflecting increasing degrees of size and international reach and increasing profiles of regulatory scrutiny posing a material risk of loss according to the risk assessment process. The analysis should consider the broad range of regulatory scrutiny that varies across a representative profile of different industries and geographies.

Benefits might be estimated based on analysis of the largest losses over the last decade in situations where the PCAOB's NOCLAR proposal is intended to either prevent or provide for earlier detection, with appropriate consideration of the ability of the auditors to play a successful role in the early detection or prevention of losses. The PCAOB should not assume all historical losses would be eliminated because there are risks that the auditor's efforts would be less than 100% successful.

The Auditors' Role

Conceptually, it is management's responsibility to determine how it manages and operates its business, subject of course to board governance. It is also the role of management and the board to assess risks and deploy strategies to manage and mitigate risks. The auditor's role is to be sure that management's reporting accurately reflects what happened rather than what should have happened.

Businesses are exposed to a myriad of business risks and losses. Some examples that come to mind are manufacturing defects, excess and obsolete inventory, new products that fail to gain customer acceptance, ineffective marketing campaigns, failure to attract and retain critical human capital, and competitors who might produce superior products at lower cost. And yes, there may be violations of laws and regulations that expose companies to large losses that could

have or should have been prevented. But isn't that the job of management coupled with oversight from the Board of Directors? Yes, it would be wonderful if these losses could be

prevented or reduced through early detection. But who has the responsibility to manage and mitigate this broad array of losses? Is it the auditors or is it management?

The answer is that the responsibility to manage risks belongs to management and the board. Capitalism is about competition. The management team that executes effectively on a good strategy and manages the relevant risks (including regulatory risks) will beat out competitors who fail to effectively manage these risks. That is how capitalism works.

There are an assortment of tools at the disposal of public company boards and executive management to manage regulatory risks. The public company board should be setting forth policies for monitoring compliance with those regulatory risks. Compliance with those policies can be monitored by various parties including internal audit, third-party specialists, or audit firms other than the incumbent auditor. Shouldn't the board and management decide how to monitor and report on such risks? If management felt like auditors were the right party to engage, there are plenty of audit firms (other than the incumbent firm) who could take on such assignments.

Lastly, external financial statement auditors are having a hard enough time executing conventional audit tasks that are well within their area of expertise. I don't think this is the time to put more on the auditor's plate that is beyond their core area of expertise.

Yes -- Auditors Need to and Can Become Aware of NOCLAR in a More Timely Manner

As it stands currently, much of the assurance the auditor receives about regulatory compliance comes from 1) the management representation letter signed by the CEO and CFO, 2) the Section 302 certifications signed by the CEO and the CFO, and 3) what is learned through legal responses to letters of audit inquiry. In the case of the first two items (the representation letter and the officer certifications), the CEO and CFO are a narrow funnel of information. In most corporations, the CEO and CFO are heavily reliant on the company's disclosure controls and procedures and cascading certifications from subordinates.

My experience as an expert witness has shown the disclosure controls and procedures are fallible. I also believe there is considerable diversity in how auditors test disclosure controls and procedures. I also believe there is considerable diversity as to how the cascading certifications are structured in terms of scope and content and whether the auditors review the information that comes through the cascading certifications.

With respect to legal letters, there is frequently a delay between when a company has visibility to a potential problem and the time an attorney is engaged and understands enough to provide a response. Furthermore, legal responses are often vague and the auditor must frequently dig to get a marginally satisfactory response.

A Reasonable Remedy

I believe the remedy is for auditors to review management's risk assessment to understand management's processes for monitoring and assuring compliance with laws and regulations (not to be confused with management's risk assessment for ICFR). The objective of that review would be to **identify the individuals with direct responsibility for compliance and monitoring within each area of regulatory responsibility posing a material risk of non-compliance. This review will yield a list of key compliance officers that the auditors should then contact to understand the complete population of NOCLAR where there is a reasonable possibility that such items might lead to a material loss. The auditors and executive management should expect to receive a quarterly written report from each key compliance officer regarding the scope their compliance programs and monitoring activities and a complete report of 1) any communications with regulators, 2) the status of any investigations and finding from investigations in process or completed, and 3) the risks associated with identified or reasonably possible threats of non-compliance that have yet to become subject to regulatory scrutiny.**

This process will provide the auditor with a much more complete picture of the threats to non-compliance with laws and regulations that can then be investigated further to assure there is appropriate disclosure and/or accrual under the financial reporting standards for contingencies.

If a company does not have the appropriate processes in place to execute on what I am proposing, that failure should be added to the list of situations in the PCAOB's ICFR standard that are highly indicative of material weaknesses in the PCAOB's ICFR standard.

I believe what I am proposing is a reasonable and cost-effective escalation in audit procedures to deal with the NOCLAR issue. If my suggestion proves ineffective, then escalation to the process proposed by the PCAOB should be reconsidered. We should remember that this problem has been lingering for decades. Yes, it needs to be resolved, but I favor an incremental approach rather than the more expansive approach proposed by the PCAOB, particularly when there is uncertainty as to whether the PCAOB's proposal will succeed and be cost-effective.

Other Suggestions (Beyond the Scope of the PCAOB)

1. I looked at a sample of recently available 10-Ks for pharmaceutical companies. I saw considerable discussion about the FDA's oversight and drug approval processes and related regulatory risks, but I saw very little about the company's compliance and monitoring programs. Might there be value in SEC disclosure requirements that describe each company's compliance and monitoring programs where non-compliance would pose a material cost to the company?
2. Regulatory compliance failures and the failure to timely report such failures should be added to the list of items that give rise to a company's ability to claw-back bonuses at both the executive level and the key compliance officer for the area where NOCLAR occurred (irrespective of whether a restatement occurred).

3. The officer certifications to section 302 and 906 have improved audit quality. However, I believe it would be beneficial to expand the signatories to include the Chief Accounting Officer and the Chief Compliance Officer. In instances where these titles do not already exist, public companies above a minimum market cap threshold should create these titles (but no one individual should hold more than one title).

I hope the PCAOB finds my suggestions helpful. Please feel free to reach out to me if the PCAOB or its professional staff have any questions about my recommendations.

Sincerely,

Robert A. Conway

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About Robert Conway -- My 360° Perspective on the Auditing Profession

I am a retired KPMG audit partner. I worked at KPMG for 26+ years, including 17 years as an audit partner. After retiring from KPMG, I joined the PCAOB where I worked from 2005 to 2014. During my last six years at the PCAOB, I was the Regional Associate Director with leadership responsibility for the PCAOB's Orange County and Los Angeles offices. Like virtually everyone else that joins the PCAOB, I was inspired by the PCAOB's important Mission to improve audit quality.

My recommendation in 2007 to the US Treasury Department's Advisory Committee on the Auditing Profession (ACAP) was widely credited with providing the impetus for ACAP's final report recommendation that the PCAOB evaluate the feasibility and potential benefits of providing public transparency to audit firm input and output measures that may be indicators of audit quality (AQIs). The PCAOB ultimately published a Concept Release on Audit Quality Indicators in June 2015. A project to study "Engagement Performance Metrics" was added to the PCAOB's Research Agenda in 2022. That project recently moved to the PCAOB's Standard Setting Agenda.

After leaving the PCAOB, I became the Professional Practice Director at CNM LLP, an 85-person regional CPA firm in Southern California that focuses exclusively on technical accounting consultations and SOX 404 outsourcing. My responsibilities put me in regular contact with Big Four audit partners, public company CFO's, Chief Accounting Officers, audit committees, and SOX Compliance Leaders. I worked at CNM for three years.

In 2019, I began serving as an expert witness in matters involving accounting, auditing, and internal controls over financial reporting. I continue to be active as an expert witness.

In 2020, I published a book titled, "**The Truth About Public Accounting – Understanding and Managing the Risks the Auditors Bring to the Audit.**"