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Via Electronic Submission

August 23, 2023

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

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

Dear Ms. Brown,

This letter is submitted on behalf of the American Bar Association's Business Law Section (the "Section") in connection with Release No. 2023-003, *Proposing Release: Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments* (the "Release") issued June 6, 2023 by the Public Company Accounting Oversight Board ("PCAOB" or the "Board") regarding proposed auditing standards for responsibilities of auditors with respect to a company's noncompliance with laws and regulations (the "Proposed Standards"). We appreciate the opportunity to comment on the Proposed Standards.

The views expressed herein have not been reviewed or approved by the House of Delegates or Board of Governors of the American Bar Association (the "ABA") and should not be construed as representing the position of the ABA. In addition, this letter does not necessarily reflect the views of all members of the Section, the drafting committee or their respective firms or clients.

I. Introduction, Statement of Interest, and Summary of Position

The Section strongly supports appropriate mechanisms to promote corporate compliance with applicable laws and regulations. Well-governed companies maintain robust corporate compliance functions and governance mechanisms, including internal compliance personnel, board and audit committee oversight, and whistleblower policies and procedures. We certainly support the general proposition that ensuring and enhancing issuer compliance with applicable laws and regulations benefits investors, shareholders and other stakeholders.

As lawyers and members of the national organization that represents lawyers, we are a profession dedicated to assisting clients in complying with the law and legal requirements. We operate under professional ethics rules that proscribe assisting a client to engage in a crime or fraud[1] and mandate reporting violations of law within a corporate governance structure that places responsibility for ensuring the company's legal compliance on its board of directors as its governing body.[2] We also strongly believe that compliance with law and effective legal representation is best served by the legal privileges protecting client confidentiality under the applicable Rules of Professional Conduct, the attorney-client evidentiary privilege, and lawyers' work product that are cornerstones of our legal system.

In this context, we are concerned about the scope and impact of the Proposed Standards, which effectively would impose an affirmative obligation on auditors to detect and evaluate all noncompliance by an audit client with law and regulations that may have a direct or indirect effect on the financial statements, even where untethered to existing accounting standards. Among other concerns, the Proposed Standards (i) place an unworkable responsibility upon accountants to make subjective assessments of often complex and uncertain legal matters, the probability of future events, and the potential impact of those events, all of which are outside the scope of auditors' typical responsibilities, (ii) endanger the confidentiality and protections of client communications that are foundational components of the lawyer-client relationship and our legal system and which are designed to promote legal compliance, (iii) risk diluting the audit function that is at the core of ensuring the integrity of financial reporting, (iv) would disrupt the separate roles played by the legal and accounting professions that benefit clients, and (v) would do the foregoing by adding costs to the audit process that will far outweigh any limited and speculative perceived benefits.

By contrast, the existing auditing standard, AS 2405, and the related statutory requirements under Section 10A of the Securities Exchange Act of 1934 (the "Exchange Act"), take a balanced approach that addresses the foregoing concerns by imposing obligations on auditors when they become aware of "illegal acts." These requirements effectively recognize that auditors cannot ignore red flags that come to their attention. This is very different than the requirement under the Proposed Standards that auditors essentially conduct a legal audit of a company's compliance with laws and regulations. The existing framework with respect to illegal acts, in contrast to the Proposed Standards, also recognizes that other mechanisms, such as regulatory oversight and responsibility of boards of directors for a company's legal compliance,

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[1] *See* American Bar Association Model Rules of Professional Conduct, Rule 1.2(d).

[2] *Id.*, Rule 1.13.

exist and that the audit function should fit within and mesh with those regimes and applicable accounting standards.

As discussed in more detail below, the Section believes that the Board should reconsider the Proposed Standards and instead should consider more modest changes to existing standards that update and enhance the auditors' responsibilities to recognize and deal with illegal acts that they become aware of in the course of an audit.

II. Legal Considerations Implicated by the Proposed Standards

The subject matter of the Proposed Standards—noncompliance with laws and regulations (sometimes referred to as "NOCLAR")—by definition involves matters of law and legal practice. We are concerned, therefore, that the Proposed Standards do not adequately take into account the inherent legal complexities and uncertainties presented by any effort to identify, evaluate and determine the potential financial statement impact of possible legal noncompliance. Depending on the nature and extent of a company's business, the legal expertise required for such an exercise could span myriad jurisdictions and practice areas. This Part discusses matters that we believe are critical to assessing the desirability and practicality of the extensive audit procedures contemplated by the Proposed Standards: (i) the current legal compliance environment for most companies and the inherent complexities involved in assessing compliance with applicable laws and regulations; (ii) the importance to the effective functioning of our system of justice of the protection of confidential client information under the Rules of Professional Conduct, the evidentiary attorney-client privilege, and attorney work product; (iii) how the existing U.S. accounting and auditing frameworks address legal complexity and uncertainty and balance investors' interest in obtaining information against the importance of protecting a company's legal privileges and avoiding prejudicing its legal position in legal and regulatory matters; and (iv) the effect of current SEC rules and sanctions that prohibit providing material false or misleading information to auditors in connection with an audit.

a. Breadth of Potentially Applicable Laws and Regulations

Companies today are subject to a vast array of laws and regulations, both those that are specific to the company's type of business and those of general applicability. Identifying and assessing the potential materiality of all laws and regulations applicable or potentially applicable to a company would involve extensive analysis and complex legal judgments, including analyzing the scope of the laws and how regulatory authorities and prosecutors might interpret and apply them to the operations of the company. The Proposed Standard also contemplates that the auditor would have to identify laws and regulations that are relevant for purposes of the standard on a prospective basis – i.e., the auditor must identify those laws and regulations that could (i.e., in the future) reasonably have a material effect on the financial statements and then must continue through the remaining steps of the proposed standard. Not only does the Proposed Standard expressly require the auditor to render prospective legal judgments as to where noncompliance could have a material impact in the future, even indirectly, the Proposed Standard also provides no time horizon as to how far into the future the auditor would have to look in making this speculative judgment of potential materiality. Moreover, whether a company has violated a law or regulation can depend on many things, including the underlying factual circumstances, uncertainties and developments in the law, government enforcement posture and priorities, as well as a company's potential defenses. In addition, the seriousness and potential consequences of a violation may vary widely based on these factors. The legal expertise to make the necessary judgments on such matters lies beyond the expertise and competence of auditors. Requiring auditors to undertake the significant legal analyses that would be required under the Proposed Standards is well outside their traditional skillsets and is not workable and at a minimum would drive inefficiencies in the audit process as well as distract auditors from their critical, core audit functions.

b. Protecting Confidential Client Information

The Release does not take into account the importance of protecting confidential client information as defined by the Rules of Professional Conduct, the evidentiary attorney-client privilege, and attorney work product to the proper functioning of our legal system. The confidentiality of attorney-client communications is a bedrock principle of the United States legal system. Under ABA Model Rule of Professional Conduct 1.6, the lawyer must hold confidential all information relating to the representation of the client (subject to limited exceptions, primarily related to criminality and fraud). This information relating to the representation, as well as communications protected by the evidentiary attorney-client privilege and the closely related work product doctrine seal the bond of trust between lawyer and client that is at the core of a lawyer's professional obligations. The fundamental value of these protections accrues to the benefit of a society governed by respect for the rule of law. These protections arise both in the context of in-house counsel advising corporate clients internally and external counsel advising those corporate clients.

As our courts have repeatedly affirmed, "attorney-client privilege is the oldest of the privileges for confidential communications known to the common law. Its purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice."[3] It is well recognized that our legal, political and economic systems depend heavily on voluntary compliance with the law and on ready access to a respected body of lawyers able to interpret and advise on matters that require legal competence. The expanding complexity of our laws and regulations increases the need for prompt, specific and unhampered lawyer-client communication. Any erosion of these protections could have a grave effect on our legal system, including on the effective functioning of corporate compliance programs. In particular, clients, if they know that their confidential communications could be subject to disclosure, would likely be less candid with their attorneys or may be deterred from seeking legal advice altogether.[4] These effects could lead to a significantly less robust, informed approach to addressing legal compliance matters as they arise. The existing confidentiality protections serve to foster legal compliance, promote the efficiency of the legal system, and encourage respect for the law – all of which the Release identifies as key objectives for a corporation but that the Proposed Standards threaten to undercut.

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[3] *United States v. Jicarilla Apache Nation*, 564 U.S. 162, 169 (2011) (quoting *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981)).

[4] *See In re Grand Jury Proceeding* (Cherney), 898 F.2d 565, 569 (7th Cir. 1990).

To satisfy the expansive requirements under the Proposed Standards (including the requirement that auditors identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements and whether there is information indicating noncompliance has or may have occurred), auditors would likely need to seek information and analysis from their audit client regarding information protected as confidential under the Rules of Professional Conduct, legal advice that has been communicated and is protected by the evidentiary attorney-client privilege, and protected attorney work product that has been prepared, to enable them to assess compliance with any given set of laws and regulations. Reports that management or their advisors have prepared regarding legal and regulatory matters in many cases will implicate confidential attorney-client communications – as these compliance matters necessarily involve legal judgments and lawyers are frequently engaged to participate in assessing and advising on such matters. Auditors may feel obligated to seek such communications given the breadth of the affirmative obligations the Proposed Standards impose on the auditor, as well as by standards governing the scope of audit evidence and documentation requirements. Disclosure to the auditor of information confidential under Model Rule 1.6, as well as information that may fall under the attorney-client privileged information to the auditor could lead to loss of privilege. For example, communications with a company's inside and outside counsel about compliance, including counsel's views regarding the outcomes and potential costs of a judicial or regulatory proceeding, will be at risk of loss of privilege if disclosed to the auditors and may result in harm to the company and its investors.[5] Similarly, with respect to the work product doctrine, while some courts have held that the work product protections remain intact even where such protected information is shared with an outside auditor, other courts have held that providing documents to an accounting firm acting as a public auditor waives whatever work product protection would otherwise attach to such documents.[6] Absent those protections, companies may be discouraged from seeking legal advice on how to navigate compliance issues. In other words, the value of obtaining legal advice regarding steps to address a compliance matter may be undercut if the communications are to be disclosed to the auditor and then appear in the auditor's workpapers. Perversely, this consequence could undermine robust compliance steps and remediation rather than enhance it. The Proposed Standard also likely would place increased pressure on auditors to seek confidential and privileged information from company counsel, which in turn also could weaken the bond of trust between lawyer and client and threaten to undermine the ethical obligation of confidentiality under Model Rule 1.6 that is a cornerstone of our U.S. legal system.

The Release fails to consider these important protections and the risk of eroding these protections if the Proposed Standards are adopted. Indeed, the fact that the phrase "attorney-client privilege" (or any related derivation) appears only once in the Release, and that "work product" does not appear at all, highlights the absence of sufficient cost-benefit analysis in this critical area. The loss of the protections of confidentiality, attorney-client privilege, and the work product doctrine for matters related to non-compliance with laws and regulations may be

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[5] *See U.S. v. Deloitte LLP*, 610 F.3d 129, 142 (D.C. Cir. 2010).

[6] *See*, *e.g.*, *U.S. v. Deloitte LLP*, 610 F.3d 129, 142 (D.C. Cir. 2010); *First Horizon Nat'l Corp. v. Houston Cas. Co.*, No. 2:15-CV-2235-SHL-DKV, 2016 WL 5867268, at *10 (W.D. Tenn. Oct. 5, 2016); *Medinol, Ltd. v. Boston Sci. Corp.*, 214 F.R.D. 113, 114-116 (S.D.N.Y. 2002); *In re Diasonics Secs. Litig.*, 1986 U.S. Dist. LEXIS 24177, at *3-4 (N.D. Cal. June 15, 1986).

highly detrimental. Matters of legal and regulatory compliance can involve a company's most sensitive business considerations. Once confidentiality and privilege are lost, the subject of the otherwise privileged communication becomes fair game for discovery in litigation. The company's adversaries could obtain invaluable roadmaps in seeking to extract damages, fines, sanctions and penalties to the greatest extent possible. The disadvantage that would result not only would seriously undermine the fairness of our adversarial justice system but also would harm investors who would ultimately bear the costs of these enhanced damages, fines, sanctions and penalties. Thus, from our perspective, the Proposed Standards threaten to create damaging uncertainties around the integrity of these core protections. As the United States Supreme Court said in *Upjohn*, "an uncertain privilege . . . is little better than no privilege at all."[7] In addition, the concerns discussed above only touch on aspects of U.S. law. The Release also does not consider the permutations of ethical obligations of confidentiality and professional secrecy, attorney-client privilege, work product doctrine and other similar protections in foreign jurisdictions.[8]

c. Existing Accounting and Auditing Frameworks

The Proposed Standards should be considered against the backdrop of the U.S. GAAP accounting framework that defines how to accrue for and/or disclose the potential financial impact of claims or possible claims arising from non-compliance with laws and regulations and the auditing framework that establishes the regime under which auditors consider potential financial statement impacts of legal noncompliance or potential noncompliance.

i. <u>Accounting Standards</u>

The Release pays little attention to Accounting Standards Codification ("ASC") 450-20, *Loss Contingencies*. ASC 450-20 establishes the framework for determining when financial statement accrual and/or disclosure is required for liabilities that may arise from a violation of law, among other things. Noncompliance with laws and regulations gives rise to a loss contingency because it could subject the reporting entity to future losses in the form of fines, penalties, damages or other costs.[9] A NOCLAR *cannot* result in a misstatement of the financial statements if the entity has appropriately accrued for and/or disclosed possible losses from the NOCLAR in accordance with ASC 450-20. Consideration of the impact of a NOCLAR on the financial statements must reflect the accounting standard and not open-ended determinations by auditors or others about whether financial statements are "misstated" or whether the NOCLAR would have other "adverse consequences," such as "restrictions on business operations, increases

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[7] 449 U.S. at 394.

[8] The Release states that auditors, in order to satisfy their expanded requirements, often will need to seek the advice of specialist legal counsel. However, the Release does not address whether communications by the auditor with legal specialists and the specialists' conclusions would be protected from disclosure to the audit client's adversary and/or government investigative agency.

[9] A "loss contingency" is defined as "[a]n existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses." ASC 450-20-20.

in costs of capital, and reputational harm," as suggested by the Release.[10] Those kinds of determinations are more appropriately made and disclosed by the company.

The ASC 450-20 framework is well understood by lawyers and accountants and for decades has established guideposts by which companies assess whether a contingent liability requires disclosure and accrual in financial statements. The standards of ASC 450-20 carefully balance the need to recognize and disclose the impact of legal contingencies in the financial statements against the adverse impact on companies and investors of premature disclosure of possible violations of law.[11]

The determinations required under ASC 450-20 involve substantial legal analysis and judgment and companies frequently engage counsel to assist them in undertaking these legal analyses. For example, evaluating the likelihood that a regulatory agency may take enforcement action based on a NOCLAR or potential NOCLAR would include counsel's evaluation of the strengths and weaknesses of a government's case, the company's defenses, communications with the agency, and the agency's enforcement policies and priorities. Evaluating the likelihood of a loss would include counsel's assessment of the evidence in the case, how the tribunal may decide questions of law or dispositive motions, evidentiary rulings, and the inherent uncertainties of litigation. The likelihood of loss evaluation would be further impacted by settlement considerations, which again would entail subjective legal judgments about the desirability of settlement versus litigation, the basis on which a settlement might be negotiated and, if applicable, the likelihood of court approval or acceptance by other claimants. Finally, reasonably estimating loss may involve factors such as the number and seriousness of the asserted violations of a law or regulation, the potential damages/fines that could result from those violations and, again, inherent litigation uncertainties. With this existing accounting standard already in place, which directly relates to topics covered by the Proposed Standards, we are of the view that any future proposal from the PCAOB in relation to NOCLAR must specifically address how such proposed standards are intended to relate to the financial statement assertions required under the accounting standard – which assertions are themselves of course separately subject to audit.

ii. <u>Auditing Standards</u>

The Release similarly fails to sufficiently discuss and consider existing requirements in Auditing Standard ("AS") 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and*

[10] *See Release* at 17. See Section IV.c.iii below for further discussion of specific provisions of the Proposed Standards that raise concerns under ASC 450-20.

[11] Indeed, beginning in the late 2000s, the FASB considered, but ultimately decided not to advance, expanded disclosure requirements regarding loss contingencies. *See* Chasen, *FASB Dumps Loss Contingency Disclosure Project*, Wall St. J. (July 10, 2012), *available at* https://www.wsj.com/articles/BL-CFOB-2328 (viewed July 11, 2023). The ABA, among others, expressed concern about the prejudicial impact certain proposed disclosures would have on companies and their investors as well as the risks the disclosures would create for fundamental attorney-client privilege and work product protections. Letter from Stephen N. Zack, President, American Bar Association, Proposed Accounting Standards Update, to Russell G. Golden, Technical Director, Financial Accounting Standards Board, "Disclosure of Certain Loss Contingencies" (the "Revised Exposure Draft"): File Reference No. 1840-100 (Sept. 20, 2010), available at https://www.fasb.org/Page/ShowPdf?path=0280-%201840-100%20AMERICAN%20BAR%20ASSOCIATION%20STEPHEN%20N.%20ZACK.pdf&title=0280-%201840-100%20AMERICAN%20BAR%20ASSOCIATION%20STEPHEN%20N.%20ZACK (viewed July 11, 2023).

Assessments. AS 2505 sets forth the auditor's responsibilities with respect to the reporting entity's accounting for loss contingencies, which, as discussed above, include NOCLAR. Together with the ABA's *Statement of Policy Regarding Lawyers' Response to Auditors' Requests for Information*,[12] AS 2505 establishes a framework for auditors to obtain confirmation regarding the company's treatment of asserted and unasserted claims. This framework balances the auditor's need for information with the lawyers' ethical obligations professional responsibilities to hold confidential all information relating to the representation of a client.[13]

AS 2505.05 recognizes that "[s]ince the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of management of an entity, management is the primary source of information about such matters."[14] The standard also recognizes that auditing a company's accounting for contingencies will involve legal considerations that are beyond the auditor's competence: "An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention."[15] Accordingly, AS 2505 provides for a written inquiry to company counsel covering matters relevant to the company's accounting for loss contingencies.[16] In certain circumstances, the auditor may also request a conference with counsel.[17]

The ABA Statement of Policy delineates the scope of the lawyer's response to auditor inquiries. Importantly, the Statement of Policy permits the lawyer to decline to provide certain information to the auditor. In particular, the lawyer does not have to respond to general inquiries regarding unasserted claims, disclosure of which could breach confidentiality and privilege and

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[12] 31 BUS LAW. 1709 (1976) [hereinafter ABA Statement of Policy], reprinted in ABA BUS. LAW SEC. AUDIT RESPONSES COMM., AUDITOR'S LETTER HANDBOOK (2d. ed. 2013) [hereinafter Handbook]. The ABA Statement of Policy is also reprinted as Exhibit II to AS 2505.

[13] According to the ABA Policy Statement,

> It is also recognized that our legal, political and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel's advice.

Handbook at 2.

[14] Current auditing standards require management to make representations regarding "[v]iolations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency and "[u]nasserted claims or assessments that the entity's lawyer has advised are probable of assertion and must be disclosed in accordance with [ASC 450-20]." AS 2805.06(p).

[15] AS 2505.06.

[16] *Id.* at 2505.08-.09.

[17] *Id.* at 2505.10.

prejudice the company.[18] Such a limitation does not constitute a scope limitation.[19] However, the lawyer is expected to confirm "that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements of [ASC 450-20]."[20] In this way, the auditor receives comfort that the lawyer's continued representation of the client indicates that the lawyer has not concluded that the client has made a material omission that would be a violation of law.

AS 2505 and the ABA Statement of Policy have provided a workable framework for almost 50 years for auditors to evaluate the adequacy of a company's accounting for loss contingencies, including those related to NOCLAR.[21] The Proposed Standards do not purport to alter the respective responsibilities of auditors and company counsel with respect to accounting for contingencies arising from NOCLAR. However, in light of the emphasis the Proposed Standards place on the auditor examining substantive legal matters, we are concerned that the Proposed Standards could lead to new forms of inquiries to company lawyers. These inquiries would raise the same types of concerns that are already adequately addressed by the ABA Statement of Policy.

d. Rule 13b2-2

The Proposed Standards also do not consider the regulatory framework that currently exists around Exchange Act Rule 13b2-2 and the incentives that Rule 13b2-2 and the SEC's enforcement thereof create to be candid and forthcoming with auditors about NOCLAR or possible NOCLAR.[22] Rule 13b2-2 prohibits directors, officers, and those acting under their direction from making materially false and misleading statements or omitting material facts to auditors in connection with a financial statement audits or the preparation or filing of a document with the SEC.

Rule 13b2-2(a) prohibits directors and officers of an issuer from directly or indirectly making false or misleading statements to accountants in connection with an audit or SEC filings. The rule also prohibits directors and officers from omitting, or causing another person to omit, any material fact necessary to make statements made to an accountant in connection with an audit or SEC filing that are not misleading. Rule 13b2-2(b) prohibits directors and officers of an issuer, or other persons acting under their direction, from taking action to coerce, manipulate,

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[18] Handbook at 5.

[19] Auditing Interpretation 17: *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of AS 2505*, at 10.31-.32.

[20] Handbook at 6; *see also* AS 2505.09f-g.

[21] *See* A. Wilson *et al.*, *The ABA Statement on Audit Responses: A Framework that Has Stood the Test of Time*, 75 BUS LAW. 2085 (2020).

[22] 17 C.F.R. § 240.13b2-2.

mislead or influence an accountant engaged in an audit or review of financial statements required to be filed with the SEC, if the person knew or should have known that such action, if successful, could result in rendering the issuer's financial statements materially misleading.

The SEC has brought or settled enforcement actions that include charges for violating 13b2-2 and we believe market participants are aware of their obligations to be candid and open with auditors about NOCLAR or potential NOCLAR. For example, in 2022, the SEC brought a settled case against officers and a director of Spyr, Inc. The SEC alleged that the defendants violated Rule 13b2-2 when they told Spyr's auditors that they were not aware of "any situations where the company may not be in compliance with any federal or state laws or government or other regulatory body regulations," even though Spyr had received a Wells notice, settlement discussions with SEC staff had broken down, and management believed that an SEC action would be filed soon.[23]

Combined with the accounting and auditing standards discussed above, Rule 13b2-2 and related cases create strong incentives for management and others to be candid and provide truthful information about potential noncompliance with laws and regulations that could materially affect the company's financial statements and the audit. They deter management and others from making misstatements in the auditing standards' required management representations, lawyers' audit letter responses, and other communications with auditors.[24]

III. General Concerns About the Proposed Standards

By making auditors directly responsible for identifying laws and regulations that could reasonably have a material effect (directly or indirectly) on the company's financial statements and for assessing whether any material noncompliance with those laws and regulations has occurred (or may have occurred), the Proposed Standards greatly expand auditors' responsibilities and functions. The Proposed Standards would expand auditors' responsibilities and functions to such a degree that it calls into question whether the underlying purpose of the Proposed Standards is to effectively give auditors oversight of and responsibility for company compliance functions, including with respect to compliance with laws and regulations that do not directly affect financial statements. Such an expansion clearly is not the province of the independent auditor under U.S. securities laws and SEC regulations. It could turn a financial statement audit into an integrated financial statement and legal compliance audit.

This is a significant departure from current PCAOB standards, which require auditors to conduct audits to obtain reasonable assurance that a company's financial statements are free of material misstatement, whether due to error or fraud.[25] While audit planning must account for the possibility of misstatements from illegal acts that have a direct and material effect on the

[23] *SEC Charges Executives and Director with Lying to Auditors*, Litig. Release 22517 (Sept. 23, 2022), *available at* https://www.sec.gov/litigation/litreleases/lr-25517 (viewed July 11, 2023).

[24] Rule 13b2-2 is also important to the auditor's responsibilities under Section 10A, insofar as it provides incentives to company management and others to cooperate with an auditor's inquiries under the section and to provide truthful information to the auditor. See discussion in Section III below, including the text accompanying notes 32-33.

[25] *See* AS 1001.02.

financial statements, there is no affirmative duty on the part of auditors to identify and make determinations regarding legal compliance matters generally.[26] The Proposed Standards depart significantly from this practice, requiring significant new proactive procedures for auditors to identify and consider noncompliance with laws and regulations which *could reasonably* have a material effect on the financial statements.[27] We believe that, in practice, this will require auditors to survey nearly all laws and regulations to which a company is subject in order to determine which of those laws and regulations could reasonably have a material effect on the financial statements. And again, in identifying those laws and regulations, the auditor would be asked to make a prospective judgment about where such noncompliance could reasonably have a material effect at some indeterminate point in the future. We are particularly concerned that the Proposed Standards would remove the existing standard's language that "an audit made in accordance with PCAOB auditing standards provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed."[28] We believe the removal of this language, combined with the significantly expanded scope of auditors' responsibilities with respect to noncompliance with laws and regulations, effectively imposes a "reasonable assurance" (or even higher) standard that will be nearly impossible to achieve in practice – particularly in light of the fact that many of the indirect effects of noncompliance that auditors will be required to evaluate are inherently uncertain, forward-looking and subject to change. We also believe these changes, in the aggregate, could have the effect of widening the "expectation gap" that we understand may be animating these rules: that is, if investors and other market participants come to believe that an audit in compliance with PCAOB standards is intended to provide reasonable assurance that there is no noncompliance with laws and regulations that could reasonably have a material effect on the financial statements, directly or indirectly, the expectation gap will be widened because such "reasonable assurance" is not practically attainable.

We also do not believe the Release adequately takes into account the expansive nature of the legal and compliance functions auditors may be required to undertake under the Proposed Standards. In order to perform the functions identified in the Proposed Standards, auditors will effectively become a "shadow" legal and compliance department for companies, making legal and compliance judgments that are in many ways duplicative of analyses that companies and their counsel already undertake and that more appropriately reside with companies and their counsel, subject to company board of directors' oversight. We note in this regard that the Release states that the Proposed Standards would "enhance [existing standards for understanding the regulatory environment] by describing the nature of laws and regulations that the auditor *should understand* as part of the audit."[29] This alone would be a significant expansion of auditor responsibilities, and we believe that the legal questions and judgments that the Proposed Standards would require auditors to make remains outside their core competencies. The PCAOB's current standards recognize this fact, and existing AS 2405 articulates the limitations on accountants' ability to evaluate legal issues, noting that "[w]hether an act is, in fact, illegal is

[26] *See* AS 2405.08.

[27] *See* Release at 5-6.

[28] AS 2405.07.

[29] *Release* at 6 (emphasis added).

a determination that is normally beyond the auditor's professional competence," and that determinations regarding illegality "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."[30]

Similar language is conspicuously omitted from the Proposed Standards. The Proposed Standards would require auditors to make numerous legal and compliance determinations throughout an audit – from determining which laws and regulations apply, to determining whether there is evidence that possible noncompliance has occurred, to evaluating instances of potential noncompliance. Although the Release notes that auditors may need to retain attorneys or other legal experts to assist in executing their responsibilities under the Proposed Standards and that such attorneys or other legal experts may be costly to retain, it does so without fully discussing the extent to which such expertise will be needed or quantifying associated costs.[31] Nor does the Release consider the effect that this requirement would have on both the accounting and legal professions, likely resulting in accounting firms having to build up their own legal capabilities and effectively developing in-house law firms. This change in the nature of the accounting profession could have profound adverse effects for companies and their accounting and legal advisers. We believe the PCAOB should engage in a more robust economic and substantive analysis that more fully attempts to quantify the costs of an audit including its expanded NOCLAR requirements, including when and how auditors would engage legal counsel under the Proposed Standards, and the consequences for companies and their accounting and legal advisers, before further proceeding. In this connection, we believe that expanding auditors' responsibilities into legal and compliance functions risks diluting their fundamental responsibility to audit and verify the integrity of a company's accounting and financial reporting.

We are also concerned that the Proposed Standards significantly expand the scope of auditor responsibilities beyond those contemplated by Congress in enacting Section 10A of the Exchange Act, which requires public company audits to include "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" (emphasis added).[32] As the Release notes, the "proposed standard would go beyond the requirements of Section 10A."[33] Specifically, as detailed above, the Proposed Standard expands the relevant scope from beyond laws that "have a *direct and material effect*" on the financial statements to laws with which noncompliance "*could reasonably have a material effect*" (emphasis added), and also would eliminate the distinction between direct and indirect financial statement impacts. Among others, these aspects of the proposal represent a significant expansion of auditor responsibilities that is inconsistent with what Congress previously determined to be appropriate and in the public interest. If Congress had intended for the PCAOB to greatly expand the definition and scope of the auditor's obligations under Section 10A, Congress could have pursued such a course within the context of passing the Sarbanes-Oxley Act itself or subsequently. We are concerned that the Proposed

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[30] AS 2405.03. We disagree with the statement on page 86 of the Release that the Proposed Standards do not require the auditor to make judgments outside their areas of expertise. To the contrary, the Proposed Standards seem to require auditors to make a number of legal determinations throughout the course of an audit.

[31] *See Release* at 79.

[32] 15 U.S.C. § 78j-1(a)(1).

[33] *Release* at 28.

Standards impose a direct and affirmative obligation on auditors to determine whether there has been legal noncompliance, which goes beyond the standard that Congress chose in Section 10A. Indeed, this expansion puts into question the PCAOB's authority to adopt the Proposed Standards in their current form. This is particularly concerning, too, in light of the lack of quantitative cost-benefit analysis in the Proposal.

IV. Comments on Specific Aspects of the Proposed Standards

a. The Definition of "Non-compliance with Laws and Regulations" as Compared to "Illegal Acts"

The Proposed Standards would replace the term "illegal acts" with "noncompliance with laws and regulations." The Release states that the Board believes that "the current scope of illegal acts is materially the same as the proposed definition [of noncompliance]."[34] However, we are concerned that this change, when combined with the other changes in the Proposed Standard, could have the unintended consequence of increasing the potential auditor liability, the costs of which will likely be passed on to audit clients and their shareholders.

The current standard essentially requires auditors to perform procedures with respect to laws that could directly and materially affect the financial statements and watch for other illegal acts and take certain actions if auditors become aware of such acts. The Proposed Standards, among other things, will require the auditors to take affirmative steps to detect instances of "noncompliance" with a much broader spectrum of laws and regulations (see discussion below of the broadened scope), including those which "could reasonably have a material effect" on the financial statements, directly or indirectly and based on a number of facts that will be unknown at the time the auditor is making such determination. The new formulation places responsibility on the auditor to detect any noncompliance, in many cases with laws and regulations over which they lack expertise. We foresee that auditors inevitably will miss some instances of such noncompliance and will incur sanctions and other liability for such misses, particularly because the auditors' assessments will necessarily be judged in hindsight once additional information comes to light or in some cases once regulatory clarity is provided.

As noted in the Release, the International Auditing and Assurance Standards Board ("IAASB") and the American Institute of Certified Public Accountants ("AICPA") have addressed NOCLAR in their standards – in International Standard on Auditing 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements* (2016) ("ISA 250") and AU-C Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* ("AU-C 250"), respectively. Both ISA 250 and AU-C 250 also use the "noncompliance" term, but they retain a narrower scope of laws and regulations and place a lower duty on the auditor for detecting noncompliance. In fact, they both contain a statement that "the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations."[35]

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[34] *Release* at 24 n. 55.

[35] Section .04 of AU-C 250 and Section .04 of ISA 250.

b. Identifying Laws and Regulations; Assessing Risks of Material Misstatement Due to NOCLAR; Identifying Information Indicating Non-compliance (Proposed AS 2405.05-.06; proposed amendments to AS 2110)

We believe that the proposed mandate to identify all laws and regulations "with which noncompliance could reasonably have a material effect on the financial statements"[36] would greatly broaden the scope of the auditor's work in ways that are well beyond auditors' current expertise and would be both unrealistic and inefficient. Companies are subject to a vast array of laws and regulations, both those that regulate the company's type of business and those of general applicability. To make sure it captures all such laws and regulations, the auditor would have to inventory all laws and regulations that apply, or may apply, to the company and then refine the list down to those that it perceives to be material. As discussed above, legal judgment would be required to determine both which laws and regulations apply or may apply, and which ones are material. Identifying and assessing the potential materiality of all laws and regulations would require complex legal judgments, including analyzing the scope of the laws and how government regulatory authorities and prosecutors apply them (or might apply them) to the operations of the company. The complexity of this endeavor would be significantly increased if the company operates in multiple states or has international operations subject to a plethora of cross-border legal requirements.

In addition, much of the effort would be outside the auditor's competency and experience. We are skeptical that it is a good use of resources to task the auditors to identify and test compliance with such varying and ever-changing laws as, e.g., environmental, labor, consumer product, cybersecurity and privacy laws.

The difficulty in applying the approach of the Proposed Standards is compounded by their requirement to assess laws and regulations that "could reasonably have a material effect" on the financial statements. Although the Release states that the auditor would not have to consider "all laws and regulations," with this newly imposed lower threshold, it is difficult to see how the auditor would be able to distinguish between those laws that are in scope and those that are not. To avoid liability exposure for failing to identify the "could reasonably" laws, auditors may be inclined to scope laws over-broadly. This would lead to a great deal of inefficiency as well as distraction away from more important matters in the audit.

Historically, auditing standards have not required auditors to embark on a general search for applicable laws and regulations. Under Section 10A and current AS 2405, auditors have a duty to report internally and, in certain circumstances, to the SEC, certain violations of law of which they became aware. To the extent the final standard includes any requirement to identify the population of laws and regulations, we think it would be better to take an approach similar to ISA 250, which retains the distinction between laws that are likely to have a direct effect on the financial statements and those that are more indirect in their effect. In addition, we believe it would be more efficient to allow the auditor to rely on a list compiled by the client of laws and regulations, as supplemented with the audit firm's experience with prior audits for the client and other companies in the industry, in each case limited to laws that are of the "direct effect" nature.

[36] Proposed AS 2110.09.

In the event a company has a problem with compliance with less obvious laws not directly related to the financial statements, it is not likely that the auditors would be the ones to identify the issue, and they should not be the first or primary line of defense. It is neither necessary nor cost effective to expand the scope of laws to address such concerns.

The Release attempts to weigh the various costs and unintended consequences of the Proposed Standards against the perceived benefits but does so without quantifying any potential such effects.[37] The analysis seems to presuppose that the broad approach proposed would deliver all the expected benefits. Given the auditors' lack of legal expertise, we question this assumption as it relates to the broader population of laws and regulations beyond those that directly affect the company and its financial statements. We expect that most of the perceived benefits would arise from strengthening the auditor's responsibilities to report noncompliance with the laws and regulations that are within the scope of the existing standard.

The economic analysis also notes that noncompliance with laws and regulations by companies may result in substantial financial injury to investors through lower share prices due to sanctions and fines, civil settlements, and legal costs, and reputational consequences for the companies, including lower future earnings and increases in the cost of capital. It is not clear how the Board weighed these potential costs against the costs associated with the expansion reflected in the Proposed Standards.

The Release analyzes the unintended consequence of diverting auditor attention away from more important aspects of the audit.[38] It concludes that the new requirements would not "unduly distract" the auditor. We consider this conclusion to be highly questionable and unsupported. The issue is not so much a matter of the level of audit effort demanded by the expanded NOCLAR requirements (although the additional costs could be significant), but rather the diversion of the attention of the senior audit staff, especially under the usual time constraints of an audit, to run down potential areas of noncompliance in areas not directly impacting the financial statements and which turn out to be unlikely to result in a material loss. Added to this burden would be the burden on both the auditor and the audit committee[39] of the additional communications required (see additional discussion at Section IV.d below).

As part of the identification process, the Proposed Standards would require the auditor to obtain an understanding of management's processes related to noncompliance with laws and regulations. While this step would provide a useful background for the auditor in assessing noncompliance, the auditor would lack the legal expertise to assess the adequacy of management's compliance processes beyond those directly related to the preparation of the financial statements.

[37] *Release* at 60-90.

[38] *Id.* at 85.

[39] "Perpetually assigning emerging risks to the audit committee (i.e., the 'kitchen sink' approach) can lead to suboptimal oversight due to overworked audit committees and a 'check the box' mentality." White Paper, *Audit Committee: the Kitchen Sink of the Board*, Center for Audit Quality, November 2022 (p.3), https://www.thecaq.org/ac-kitchen-sink (viewed Aug. 17, 2023).

c. Evaluating Compliance with Laws and Regulations, Remedial Actions (Proposed AS 2405.07-.11)

i. In General

The Proposed Standards would thrust the auditor into the role of compliance arbiter on purely legal matters, thus necessitating the engagement by the auditor of lawyers and other advisers. The Proposed Standards would require auditors to follow a rigorous two-step process each time the "auditor identifies or otherwise becomes aware of information indicating that noncompliance with laws or regulations, including fraud, has or may have occurred (regardless of whether the effect of such noncompliance is perceived to be material to the financial statements) . . . ." The "has or may have occurred" standard is exceedingly low and divorced from other thresholds related to loss contingency matters. For example, the governing standard for loss contingency disclosures under ASC 450-20 requires that a loss contingency at least be "reasonably possible" for disclosure purposes.[40] The ABA Statement of Policy contemplates that lawyers will respond to auditors as prescribed with regard to matters that involve overtly threatened or pending litigation, including instances in which a potential claimant has "manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote."[41]

In contrast, the Proposed Standards would require auditors to consider whether noncompliance may have occurred, which will indeed be a legal determination in many instances, without any existing framework to engage with those in the legal profession, short of engaging counsel to advise the audit firm. Moreover, even assuming the auditor engaged counsel in this regard, the Proposed Standards leave unanswered how the auditor is to reconcile the findings from such a broad assessment of noncompliance with the governing accounting disclosure rules established by the FASB. In other words, the Proposed Standards fail to align with the assertions under audit in this respect. Several provisions in proposed AS 2405 illustrate this concern, including the following proposed requirements:

- **AS 2405.07(2)**: the auditor must "determine whether it is *likely* that any such noncompliance has occurred."
- **AS 2405.08**: audit procedures to understand the nature and circumstances of noncompliance with laws and regulations and the likelihood of such occurrence may include:

> "d. confirming significant information concerning the events or transactions with . . . legal counsel, or others who may have knowledge of the events, transactions, and applicable legal requirements"; and
>
> "g. Discussing the facts and circumstances with the company's legal counsel or others with specialized skill or knowledge about the application of relevant laws

[40] ASC 450-20-50-2A.

[41] ABA Statement of Policy ¶ 5.

> or regulations to the circumstances and the possible effects on the financial statements."

The Proposed Standards would require auditors to make a probability determination as to a company's compliance with laws. Not only would they put the auditor at the crossroads of making a legal determination, they would necessarily require significant skill and judgment in assessing legal outcomes in less-than-clear scenarios.

As the Proposed Standards recognize, auditors may need to engage legal counsel to assist in making these determinations and potentially engage with the audit client's legal counsel. Specifically, Note 1 to proposed AS 2405.07 states, "The auditor should consider whether specialized skill or knowledge is needed to assist the auditor in evaluating the noncompliance." Assuming that the auditor will require outside legal advisors to advise the auditor in regards to satisfying the Proposed Standards, that raises a question as to whether law firms with requisite capabilities and experience in complex areas of law would be available or willing to advise auditors on these matters, particularly given that the advice of such counsel (which normally would be confidential to the client) presumably would in many instances have to be included in workpapers and potentially not subject to privilege for the reasons discussed above.[42] Additionally, for audits of large multi-national companies that often engage several law firms for counsel, audit firms may find it challenging to locate legal counsel with the requisite expertise and without an existing conflict based on the law firm's representation of the audit client. For audit clients in heavily regulated industries, the task of finding such counsel could be all the more challenging. Even putting aside these practical challenges, engaging legal counsel with skills in these areas will inevitably result in significant costs (including increases in costs of public company audits) with an uncertain economic justification relative to the aims of the Proposed Standards.

Unresolved in the Proposed Standards is how the auditor is to reconcile differences of views between the auditor's legal counsel and legal counsel to the client. To help overcome these differences of opinion, or prevent them in the first instance, audit clients may feel pressured to instruct their legal counsel to share more information with the auditor about a matter than required under the confines of the ABA Statement of Policy. As discussed earlier, this could significantly undercut the protections of confidentiality and the attorney-client privilege and could undermine the protections afforded by the ABA Statement of Policy.[43]

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[42] Audit workpapers are subject to disclosure to the PCAOB for purposes of inspections and disciplinary proceedings. As such, there can be no expectation of confidentiality as it relates to information set forth in auditor workpapers. *See* 15 U.S.C. § 7215; PCAOB Rule 4006. There are also doubts as to whether work product protection would apply, both because the lawyer reports may not be considered to be prepared in anticipation of litigation or because the PCAOB, as a regulator, would be deemed to be "adverse" to the auditor. *See supra* notes 5-6 and accompanying text. Additionally, under ABA Model Rule of Professional Conduct 1.6, the lawyer must hold confidential all information relating to the representation of the client and may not disclose such information absent informed client consent.

[43] *See* A. Wilson *et al.*, *The ABA Statement on Audit Responses: A Framework that Has Stood the Test of Time*, 75 BUS LAW. 2085 (2020) (explaining the enduring structure of the ABA Statement of Policy and the careful balance struck between the legal and accounting professions to protect the attorney-client privilege).

The legal and regulatory environment in the United States is fraught with uncertainties, with laws and regulations subject to significant interpretation that can vary from case to case based on the specific facts and circumstances. The precision sought by the Proposed Standards is an illusory goal due to the unpredictability of many legal and regulatory matters. To task auditors with ultimate authority to assess probability as to a panoply of nuanced legal questions, particularly for companies in heavily regulated industries, is unsound and bad policy.

ii. Auditor Independence Considerations

Regulation S-X 2-01(c)(4) sets forth a non-exclusive list of proscribed non-audit services that impair an auditor's independence, including:

> (vi) *Management functions*. Acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.
> . . .
> (ix) *Legal services*. 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.[44]

The Proposed Standards acknowledge that the auditor is required to be independent of the audit client.[45] The Proposed Standards do not, however, explain how the audit procedures required under the Proposed Standards, including the assessment of the likelihood of noncompliance with laws and regulations and the concurrent reporting obligations to both management and the audit committee (discussed further below), would not impair the auditor's independence. If auditors are engaging legal advisors to assist in evaluating and assessing an audit client's noncompliance with laws and regulations, and then communicating with audit clients about those conclusions, it could be argued that such activities amount to a management function and/or legal advice, and therefore impairs the auditor's independence. Admittedly, the activities contemplated by the Proposed Standards are in the context of an audit engagement, but given the potential volume of laws and regulations that may be considered by an auditor and then shared with the audit client, a question arises as to when the output and communications from the audit procedures might more closely resemble a prohibited non-audit service.

iii. Existing Accounting Standard Considerations

As discussed above, the accounting for loss contingencies is governed by ASC 450-20. Given the potential breadth of the laws and regulations that could apply to an audit client, without grounding in the underlying accounting framework, the Proposed Standards could put the auditor in the position of auditing and accumulating audit evidence for matters that may not be subject to disclosure or accrual in the financial statements. Several provisions in the Proposed Standards illustrate this concern. For instance:

[44] Regulation S-X Rule 2-01(c)(4)(vi), (ix), 17 C.F.R. § 210.2-01(c)(4)(vi), (ix).

[45] *Release* at 69 n. 140 (citing Regulation S-X Rule 2-01, 17 C.F.R. § 210.2-01).

- Proposed AS 2405.09a would require that auditors "determine the *possible effect* of the likely noncompliance on the financial statements." The term "possible effect" has no analog in the ASC 450-20 framework. There, disclosures are based primarily on materiality and probability, falling into one of three categories – remote, reasonably possible, or probable. By starting with a determination of the "possible effect" of likely noncompliance, the auditor is being tasked with undertaking a broader assessment of the matter than may be required for disclosure or accrual under ASC 450-20.

- Proposed AS 2405.10b refers to "the effect on the amounts and disclosures in the financial statements, *including* potential contingent monetary effects." It is unclear what types of effects (other than accounting for loss contingencies) are envisaged by the PCAOB. As noted, ASC 450-20 governs the disclosure of loss contingencies. Further articulating the expected analysis to be undertaken by auditors in this respect would be useful to better inform the judgments expected to be made by auditors with respect to an audit client's application of accounting standards in the context of potential noncompliance.

- Proposed AS 2405.10c requires that the auditor consider the "adequacy of disclosure in the financial statements of the likely noncompliance on the company's operations." This implies that there will be disclosure about "likely noncompliance" in a company's financial statements. Similar to the discussion above as it relates to ASC 450-20, in many instances no disclosure is required in the financial statements as an accounting matter. The PCAOB, through the Proposed Standards, and especially through this provision, should not be prescribing what amounts to an independent disclosure standard that is detached from the accounting standards applicable to the financial statements being audited.

Finally, we are concerned that a purported auditing standard untethered from the accounting standards to which it relates is not really an auditing standard but rather an effort to impose requirements on companies designed to ensure their legal compliance or disclosure of noncompliance. As noted above, such actions raise questions about whether the PCAOB is exceeding the authority granted to it by Congress in the Sarbanes-Oxley Act.[46]

d. Communications Regarding NOCLAR (Proposed AS 2405.12-.15)

Proposed AS 2405.12-15 sets forth a heavily prescriptive communication regime regarding noncompliance with laws and regulations that threatens to overload audit committees and management. This section appears to reflect a suspicion that management will not be forthcoming with the audit committee regarding possible issues of noncompliance. While we

[46] Note that the scope of the Board's regulatory power is limited to "audit reports." 15 U.S.C. § 7211(a). "Audit report" is a "document or other record . . . prepared following an audit." *Id*. § 7201(a)(4). "Audit," in turn, is defined as "an examination of the financial statements of any issuer . . . for the purpose of expressing an opinion on such statements." *Id*. § 7201(a)(2). In this context, the auditor's responsibility under SOX extends to auditing the company's accounting for loss contingencies, but it may not encompass more generally assessments of legal compliance.

recognize that the auditors must exercise professional skepticism, we believe that the Proposed Standards are overly prescriptive in this regard and risk turning auditors into de facto managers of the audit client's compliance function, a role that as noted above presents independence concerns.

For example, proposed AS 2405.12b requires the auditor to communicate to management and the audit committee "information indicating that noncompliance with laws and regulations (*whether or not perceived to have a material effect on the financial statements*) . . . *has or may have occurred*" (emphasis added). The reporting is required "as soon as practicable," including before the auditor is able to complete its evaluation of the information to determine whether any noncompliance has or may have occurred and/or whether it is material.[47] This may result in extensive communications to the audit committee by the auditors about legal compliance matters, even routine ones that have not been determined to involve likely noncompliance, or that may be immaterial, and ones which management has already discussed with the committee (and the auditors). Consideration of these matters is likely to divert audit committee resources and may dilute committee focus on information that is more likely to impact the financial statements. Additionally, audit committee members may need to expend significant resources considering the information that is shared with them in response to the Proposed Standards, particularly in light of the monitoring and oversight duties that directors have and the potential for audit committee members to become aware of a significant number of additional "red flags." Although the proposed standard allows auditors to exclude "clearly inconsequential" matters, auditors may be reluctant to do so, because the "as soon as practicable" requirement built into the standard suggests a preference for reporting even before a meaningful evaluation of the potential noncompliance can be performed. At a time when audit committees are being asked to take on increasingly more responsibilities and there are calls to better manage the audit committee workload,[48] we urge the PCAOB to seriously consider a more measured requirement in the interest of providing more thoroughly vetted information to audit committees. In that vein, we strongly urge the PCAOB to consider whether the Proposed Standards, if adopted as proposed, will change the expectations and duties of audit committee members to such a degree that there is a chilling effect on audit committee members' willingness to serve, shrinking the pool of qualified candidates and having a deleterious effect on audit committee quality, which would ultimately serve to hurt investors and the capital markets.

e. Multi-Location Engagements (Proposed AS 2405.16-.17)

Proposed AS 2405.16-17 sets forth parameters for lead auditors to establish in multi-location engagements. The Proposed Standards contemplate that other auditors participating in the engagement will communicate information about noncompliance with laws and regulations to the lead auditor. While we appreciate the audit requirements that this is expected to address, we have concerns about its implementation in practice. Related to the above concerns about auditors making legal determinations, this aspect of the Proposed Standards further confounds

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[47] *See Release* at A1-7 n. 17.

[48] *See* Panel Discussion Regarding Audit Committee Workload and Transparency at U.S. Securities and Exchange Commission Investor Advisory Committee Meeting (June 22, 2023); Center for Audit Quality, Audit Committee: The Kitchen Sink of the Board (November 2022), https://www.thecaq.org/ac-kitchen-sink (viewed Aug. 17, 2023).

that issue by introducing foreign legal and regulatory requirements and potential differences in those legal requirements as compared to corresponding US legal requirements. Moreover, for non-US subsidiaries of a US parent company, is it the case that the Proposed Standards would require non-lead auditors on the engagement to engage both local and US counsel to advise on potential noncompliance with laws and regulations matters so that the other auditor and lead auditor could satisfy their applicable obligations under the Proposed Standards? If so, putting aside the complexity associated with legal privileges and involvement of potentially several local counsels, this again puts the lead auditor in the untenable position of potentially deciding the import of legal questions, including from a foreign law perspective, which is not a task best suited for auditors to undertake.

f. Effect on the Engagement Report (Proposed AS 2405.19)

Proposed AS 2405.19 requires the auditor to "determine the effect on the engagement report and the ongoing relationship with the company" if any of the three categories of considerations set out in proposed AS 2405.19 are identified. The Proposed Standards do not provide more specific guidance on the impact to the audit report if these considerations are identified. One implication might be that audit reports must be "qualified" if the auditor is "precluded" from obtaining information or evidence or is "unable to determine" whether likely NOCLAR has a material effect on financial statements, for instance. It is unclear from the Proposed Standards what the desired effect on the audit report would be in that instance. Given that many legal questions involve uncertainty, as explained above, there could be a significant number of situations in which the auditor is unable to conclude whether likely noncompliance has a material effect on the financial statements. That should not result in a qualified opinion.

g. Specialists (AS 1201.C3d-e, C6d)

Proposed amendments to AS 1201 to add new AS 1201.C3d-e impose on specialists a duty to communicate information about NOCLAR that the specialist becomes aware of, and to attest that it has done so. Auditor-employed specialists are not necessarily attuned to the specific audit requirements that must be considered to complete an audit and they may not appreciate the total context in which a matter arises in order to assess its materiality. Therefore, imposing upon them a requirement to make such communications would significantly expand the role and responsibilities of auditor-employed specialists. That could significantly increase the costs of the audit, particularly where the instances of potential noncompliance that must be reported to the auditor are not limited to laws and regulations appurtenant to the area of expertise for which the specialist is engaged.

V. Conclusion

We strongly encourage the Board to reconsider the Proposed Standards. The lack of an adequate economic analysis of the Proposed Standards and the anticipated risks to the legal and accounting professions cannot be understated. As this letter illustrates, we have serious concerns about the scope and impact of the Proposed Standards. We indeed support the general proposition that ensuring and enhancing issuer compliance with applicable laws and regulations benefits investors, shareholders and other stakeholders, but we remain convinced that the competing interests at issue in the Proposed Standards can be more carefully and efficiently balanced. To that end, we would be delighted to discuss these matters with the Board and PCAOB staff.

Very truly yours,

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Chair of the ABA Business Law Section

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