

Comments of Dr. Sridhar Ramamoorti on the PCAOB's Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments

BACKGROUND: On June 6, 2023, the Public Company Accounting Oversight Board (the Board or PCAOB) issued a request for comment on its *Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments* (PCAOB 2023b).

As a former member of the PCAOB's Standing Advisory Group, I wanted to submit my comments on this proposal. My detailed letter below expresses strong reservations about the merits of this PCAOB proposal. Based on careful consideration from several points of view, I concur with the dissenting views of the two CPA members of the PCAOB and do not support the NOCLAR proposal going forward.

My name is Sri Ramamoorti and I am currently an Associate Professor of Accounting at the University of Dayton in Ohio. I teach graduate courses on fraud examination and forensic accounting, as well as accounting and business ethics.

As a former member of the PCAOB's Standing Advisory Group (SAG, now referred to as SEIAG), not seeing any obvious triggering event, I was quite surprised by the PCAOB's proposed *Amendments Related to a Company's NOCLAR and Other Related Amendments*. In my considered opinion, this proposed Amendment, if adopted, is a bridge too far and will completely change the purpose, nature, and scope of the auditing profession as we know it. It fails to consider the Company management's primary responsibility for mitigating the risk of NOCLAR, including the existing structures and processes comprising the Company's own legal department, internal audit function, risk management and compliance personnel, etc. Instead, the PCAOB plans to burden the independent/external auditor with this responsibility in areas of the law where they do not have professional competence. Further, the lack of a thoughtful and well-supported economic analysis of the proposed NOCLAR standard is a fatal flaw and does not allow one to take it seriously.

A Government of Laws and Not of Men

Arguing in the vein of Aristotle, Livy and Harrington, in the Fall of 1774, in *The Novanglus Letters*, John Adams famously wrote ours is "a government of laws and not of men."¹¹

So, as a nation of laws, I understand very well why the PCAOB wants to ensure that auditors have thoroughly vetted potential or actual instances of noncompliance with laws and regulations (NOCLAR) that would materially affect the financial statement presentation of U.S. companies. While such a proposal places a heavy burden on the larger public accounting firms, it is debatable whether smaller firms even have the capacity to assume such a role. In my assessment, the Big Four firm auditor concentration risk will only worsen as a consequence of such a NOCLAR standard being adopted.

But allow me to ask a blunt question: **Does the PCAOB want lawyers to take over the auditing profession?** In such a contemplated reconstruction of the auditing profession, like in most forensic

¹¹ *The Revolutionary Writings of John Adams*, Selected and with a Foreword by C. Bradley Thompson, "The Report of a Constitution, or Form of Government, for the Commonwealth of Massachusetts" (Indianapolis: Liberty Fund, 2000) (excerpt title added by Dr. Tierney) (italics added by Dr. Tierney).

accounting contexts that I am familiar with, the forensic/public accountants would work for a law firm and at the direction of attorneys. They also would have attorney-client privilege. But in such a scenario the audit of financial statements would be conducted by a law firm, with the public accountants playing a secondary role.

Consider a thought experiment. Given the importance of NOCLAR to the PCAOB, why not go the whole way? Why not have the auditors attend every client Company Board meeting, as well as management strategy formulation and execution meetings, to ensure that the NOCLAR possibility is minimized (even eliminated). After all, such an arrangement would arguably have stopped NOCLAR in the case of “Pharma Bro” Martin Shkreli, then CEO of Turing Pharmaceuticals, who made \$64.6 million in illicit profits by hiking the price of life-saving drug Daraprim by more than 5000% overnight. The auditor could have shut the whole thing down before Shkreli acted on his ill-advised price hike.

Realistically though, in addition to violating several professional standards pertaining to accountants in public practice (management participation, self-review risk, lack of professional competence in matters of the law, etc.) that sort of outrageous thought experiment remains very much a hypothetical consideration and cannot be seriously entertained in a real-world scenario. This is a sort of proof by contradiction in that the premise itself is false.

Historically, professional standards have enjoined CPAs not to take on engagements where they lack professional competence. Paragraph 3 of the AICPA’s AU 317: *Illegal Acts By Clients* that became effective from January 1, 1989, reads:

“Dependence on Legal Judgment

.03 Whether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence. An auditor, in reporting on financial statements, presents himself as one who is proficient in accounting and auditing. The auditor's training, experience, and understanding of the client and its industry may provide a basis for recognition that some client acts coming to his attention may be illegal. However, the 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 logic here seems crystal clear and straight forward. Hence, it befuddles me as to why the PCAOB would want auditors to take on the responsibilities of lawyers (even if their professionals were suitably qualified and held both a CPA and JD)? What if an accounting firm simply cannot find lawyers to work for them in areas involving murky interpretations of the law, e.g., the crypto-asset or emerging technologies space? Indeed, what was the triggering event that made the PCAOB go down this NOCLAR path with respect to public accounting firms? The NOCLAR proposal appears to be a poorly crafted solution in search of a non-existent problem.

Also consider that in a new regime where the proposed PCAOB Amendment has been adopted, it would be extremely risky and dangerous for accounting firms to have anything to do with companies operating in the crypto asset or fintech space, as many unsettled legal issues persist in these areas. For smaller accounting firms, given the plethora of U.S. laws and regulations to contend with this proposal is a non-starter—it is just not feasible and very much beyond their capacity.

The excessively broad sweep of the proposed standard raises many thorny and problematic issues. As I remarked earlier, in my opinion, if these NOCLAR Amendments are adopted, everything about the auditing function would be unrecognizably altered. Perhaps that is why the two CPA members of the Board, DesParte and Ho, have expressed their strong dissent on this matter. I agree with their position.

Enter Lewis Carroll: Language and Philosophy--Who is the Master?

Here's an oft-quoted passage from University of Oxford mathematics professor Lewis Carroll's novel *Through the Looking Glass* (1872):

'...and that shows that there are three hundred and sixty-four days when you might get un-birthday presents—'

'Certainly,' said Alice.

'And only *one* for birthday presents, you know. There's glory for you!'

'I don't know what you mean by "glory",' Alice said.

'Humpty Dumpty smiled contemptuously. 'Of course you don't--till I tell you. I meant "there's a nice knock-down argument for you!"'

'But "glory" doesn't mean "a nice knock-down argument", Alice objected.

'When *I* use a word,' Humpty Dumpty said in rather a scornful tone, 'it means just what I choose it to mean--neither more nor less.'

'The question is,' said Alice, 'whether you *can* make words mean different things--that's all.'

'The question is,' said Humpty Dumpty, 'which is to be master--that's all.'

Indeed, it may be legitimately asked which is to be master, the *concept of economic income* or *the context of income resulting from a legislative or regulatory audit*?

We are back to accountants or lawyers—who do we wish to be the master in the audit of financial statements? The former preserves the primacy of public accountants *qua* public accountants in the financial reporting and audit process, while the latter makes laws and regulations have primacy, making lawyers primary and accountants and auditors secondary. I should note that the markets are familiar with the concept of economic income (Haig-Simons-Hicks, or HSH = consumption plus change in net worth, harking back to academic literature in economics from the 1930s), but may be unfamiliar with what a legislative or regulatory audit might portend for income numbers and more broadly, the financial statements taken as a whole. It would introduce yet another sieve that the income calculations and the financial statements will have to go through before being pronounced acceptable and legitimate.

The implications are many:

1. **Accounting curricula:** Accounting education will have to change drastically, with the curriculum containing a much heavier emphasis on laws and regulations. Most importantly, students must be taught the critical distinction between the letter of and the spirit behind the law. They will also need to learn to work with lawyers much more closely (something that already happens with CPAs and lawyers in the forensics and valuation space, my own area of specialization). CPAs of the future should dedicate themselves to wanting to obtain a JD as well to be better equipped and more relevant in such an environment.
2. **Accounting enrollments:** Given the decline in accounting enrollments, it is unclear that this new proposal will have a salutary effect on student enrollments—it may well cause a further chilling effect, creating severe staff shortages going forward.
3. **Audit fees:** Clients are unlikely to pay significantly increased audit fees for firms to cope with these new requirements, if adopted. That would squeeze audit firms even further. (It would have been helpful if a PCAOB cost-benefit analysis had considered this aspect).
4. **Lawyers as specialists?** Auditors will need to bring armies of lawyers as specialists on audit teams to ensure that NOCLAR is appropriately dealt with. There is a risk that auditors may not be able to do full justice to the “traditional audit”—there are only 24 hours in a day, and the massive scope creep contemplated here cannot be easily handled, something has to give. As Nobel Laureate Herbert Simon observed: “A wealth of information creates a poverty of attention.” And on occasion, such “specialist” lawyers may not be available, or may not be willing to participate in such work because of the personal legal risks involved. There is possibility that meeting NOCLAR standards may be infeasible or distract from the focus on financial statement audits, even potentially lower audit quality. (This would defeat the PCAOB’s goal of improving audit quality).

After considering these matters, I am persuaded that by proceeding with this Amendment to NOCLAR standards the PCAOB would be taking an unwise step. I implore the PCAOB to consider the many letters arguing against this NOCLAR proposal and include me among the dissenting group of commenters.

In closing, my participation as a PCAOB SAG member has been one of the more rewarding professional experiences in my career. Accordingly, I want to actively contribute to the comment letter process. Should you have any questions or would like to discuss my response letter further, I would be happy to make myself available, including making a trip to Washington D.C., if necessary.

Sincerely,

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