August 4, 2023

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

VIA EMAIL

Re.: *PCAOB Release No. 2023-003 – A Company's Noncompliance with Laws and Regulations*

Dear Sir or Madam:

The Committee on Capital Markets Regulation (the "Committee") is grateful for the opportunity to provide comments to the Public Company Accounting Oversight Board ("PCAOB") on its proposed amendments to auditing standards related to an auditor's responsibility for considering a company's noncompliance with laws and regulations (the "Proposal").[1]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-seven leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Emeritus Dean, Columbia Business School) and John L. Thornton (Former Chairman, The Brookings Institution) and is led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

Part I describes how the Proposal would depart radically from existing accounting standards by requiring auditors of SEC-registered companies to monitor for and identify instances of noncompliance with laws and regulations regardless of whether the noncompliance would have a direct and material effect on the company's financial statements. Part II assesses the effect of these changes and their policy rationale. We find that the Proposal would in effect require auditors to function as lawyers, and that the PCAOB has not identified any policy rationale that justifies such a radical and costly departure from current standards. We find also that the Proposal would require auditors and companies to adopt extremely costly alterations to their existing procedures and control functions without benefiting the users of financial statements. The Proposal could also require companies to violate other legal obligations. Furthermore, the Proposal's economic analysis fails to substantiate the purported benefits of its changes and also fails to consider or quantify several significant costs. It also likely exceeds the PCAOB's statutory authority. The

[1] Public Company Accounting Oversight Board ["PCAOB"], *Amendments to PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments* (June 6, 2023), https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket-051/pcaob-release-no.-2023-003---noclar.pdf?sfvrsn=fe43e8a_4 [the "Proposal"].

Committee therefore calls on the PCAOB to withdraw the Proposal and engage further with key stakeholders, including audit firms and public companies, before issuing a revised proposal that increases audit quality and protects investors' interests through tailored and practicable reforms.

I. Overview of the Proposal

PCAOB rules govern accounting firms' audits of SEC-registered companies.[2] Under current PCAOB rules, an auditor's duty to detect a company's noncompliance with laws and regulations is limited to noncompliance that has a "direct and material effect" on the company's financial statements.[3]

For example, if a company violates a law governing the billing practices of government contractors in a manner that undermines the company's legal entitlement to amounts it has billed, the noncompliance potentially results in an overstatement of the company's revenue.[4] The auditor must therefore review the company's compliance with such laws to ensure that the amount of reported revenue is not materially inaccurate. However, the auditor is not required to monitor for minor infractions of such laws that would not result in a material inaccuracy. Nor is an auditor required to identify noncompliance with laws that only have an indirect effect on the company's financial statements. For example, an auditor is generally not required to review a company's compliance with occupational health and safety laws, even if a violation could result in a material monetary fine, because a violation does not directly affect the accuracy of amounts reported on the financial statements.[5]

The current standard thus recognizes that auditors' core function is to ensure financial statements are not materially inaccurate and that the assessment of legality is normally "beyond the auditor's professional competence."[6] Therefore, auditors should generally only be responsible for monitoring compliance with laws and regulations to the extent noncompliance directly results in a material inaccuracy in the financial statements. However, the Proposal would erase this distinction and require auditors to monitor for and identify instances of noncompliance that are immaterial or do not directly affect the financial statements.[7] More specifically, the auditor would be required to identify all laws and regulations with which noncompliance "could reasonably" have a material effect on the financial statements.[8] The threshold for "could reasonably" is undefined and could encompass all laws and regulations to which a company is subject. The auditor would then "plan and perform procedures to identify whether there is information indicating noncompliance has or may have occurred.[9]" Notably, this requirement is unqualified by materiality or whether the noncompliance would directly affect the financial statements. Thus, in the examples above, the

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[2] PCAOB, About, https://pcaobus.org/about (last visited July 25, 2023).
[3] Accounting Standard 2405 ("Illegal Acts by Clients"), https://pcaobus.org/oversight/standards/auditing-standards/details/AS2405.
[4] *Id*. at paragraph .05.
[5] *Id*. at paragraph .06.
[6] *Id*. at paragraph .03.
[7] Proposal, Appendix A, paragraphs .04C, .A2.
[8] *Id*. at 5.
[9] *Id*. at 31.

Proposal would require the auditor to implement procedures to detect even immaterial noncompliance with such billing laws, and to assess the company's compliance with occupational health and safety laws, even though noncompliance would not directly affect the accuracy of the company's financials.

II. Analysis of the Proposal

In this Part II we identify six major issues with the Proposal that should compel the PCAOB to withdraw it before reissuing a revised proposal. First, the Proposal does not articulate a cognizable policy rationale for its radical expansion of auditors' traditional duties, which would effectively require auditors to function as lawyers. Second, the Proposal would produce extreme costs and unworkable compliance burdens for both auditors and public companies while failing to produce meaningful information for investors. Third, compliance with the Proposal would often be impossible without violating other legal requirements. Fourth, the Proposal would distort U.S. capital markets by disincentivizing companies from going public. Fifth, the Proposal's economic analysis fails to substantiate any of its purported benefits or to adequately consider or quantify any of its significant costs. Sixth, the Proposal likely exceeds the PCAOB's statutory authority.

1. The Proposal fails to identify a coherent policy rationale.

The Proposal would effectively require auditors to function as lawyers by making them responsible for monitoring for instances of companies' potential noncompliance with laws and regulations and analyzing whether such instances are in fact illegal, regardless of whether the noncompliance is ultimately relevant to the company's financial statements. The Proposal contends that this radical alteration of auditors' traditional duties is needed because existing standards do not "clearly articulate" the auditor's responsibility for "identifying and responding" to potential noncompliance and because auditors "have disincentives that may keep that from playing a significant role in identifying companies' noncompliance with laws and regulations" and that investor harm from such violations "can be significant."[10] These explanations do not support the changes the Proposal would make.

First, if existing standards do not "clearly articulate" auditors' responsibilities, this would support a rewording of existing standards to clarify what they entail. But the Proposal is not a clarification of existing standards; it is a radical substantive departure from them. Second, merely identifying that auditors may have incentives not to play a significant role in identifying noncompliance amounts to the trivial observation that auditors are actually focused on fulfilling their discrete legal duties and professional responsibilities. It also provides no reason to conclude that auditors *should* play a larger role in identifying noncompliance as a policy matter. Third, the existence of instances in which a company's noncompliance with laws or regulations produced costs for investors provides no basis to claim that the noncompliance was attributable to the limits on auditors' responsibilities or that expanding auditors' responsibilities would reduce noncompliance.

[10] Proposal at 18-19.

2. The Proposal would require extremely costly adjustments to existing audit, compliance, and other functions.

The Proposal will require auditors to duplicate and significantly expand many functions that companies perform internally by enacting procedures that will allow them first to identify any relevant laws and regulations that apply *or may apply* to a company that could reasonably have a material effect on the financial statements and then to detect any violations of such laws and regulations, even if they are immaterial. Creating and carrying out these procedures will entail significant costs for auditors, many of which they are likely to pass on to companies in the form of higher audit fees. Companies too will also face large cost increases since they will be forced to restructure and expand many or all of their internal departments, including but not limited to their compliance, tax, and human resources functions, to provide auditors with access to information necessary for the auditors to meet their expanded responsibilities.

More generally, the Proposal would require auditors to function as lawyers and enforcement officials, tasks which current PCAOB standards recognize are outside auditors' professional competence. The Proposal will thus result in structural inefficiencies by requiring auditors to acquire knowledge and expertise that does not relate to their core competencies. And since compliance with a particular law or regulation will in many cases be unclear or subject to interpretation, the Proposal will also likely result in protracted discussions or disputes between auditors and companies' internal or external legal counsel regarding the legality or reasonableness of a multitude of issues. These issues will be particularly pronounced for companies in the financial sector, such as banks, which are subject to numerous complex regulatory regimes, including extremely complex regulatory capital requirements.

Moreover, the Proposal would task auditors with identifying noncompliance that is ultimately immaterial and not reported on financial statements. Such instances of immaterial noncompliance may be numerous and complex, especially in the case of larger organizations, and require significant time and effort to identify. And, as a result, much of the cost and regulatory burden the Proposal entails will not produce any useful information for investors.

3. Complying with the Proposal could entail noncompliance with other laws.

Compliance with the Proposal could in some cases entail noncompliance with another law, thus undercutting the very purpose the Proposal is purported to serve. As merely one example, the supervisory communications of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (the "U.S. Banking Agencies") and supervised institutions' responses to the U.S. Banking Agencies are considered "confidential supervisory information" ("CSI"). CSI is communicated for the purpose of facilitating the supervised institutions' compliance with regulatory capital and other requirements and remains property of the U.S. Banking Agencies which no person to whom the information is made available may use for any unauthorized purpose or disclose unless authorized. Supervised institutions may only share CSI with auditors "when necessary or appropriate" in

connection with auditing services.[11] Under current PCAOB standards, auditors generally do not require access to such information, because noncompliance with regulatory capital requirements does not directly affect the accuracy of a bank's financial statements. However, the Proposal could conceivably require an auditor to demand access to such information on the basis that a bank may be in noncompliance with regulatory capital requirements. In many such situations it may be unclear whether disclosure is "necessary or appropriate" in connection with the audit of a supervised institution's *financial statements*, and both the auditor and the bank could be at risk of violating their respective legal obligations. The Proposal might also compel auditors to demand access to other confidential information, such as customer data, the sharing of which could result in legal liability, or legally privileged information, such as opinions of legal counsel, the sharing of which could result in the loss of privilege.

4. The Proposal would distort U.S. capital markets.

The Proposal would increase the burdens imposed on companies that access public markets compared to those that remain private. The Proposal will thus distort U.S. capital markets by incentivizing companies that would otherwise seek access to public markets to remain private. This would accelerate the decline of the role of the U.S. public equity market relative to its private counterpart. The Committee has previously highlighted this trend and its detriments to U.S. capital markets, including limiting the access of retail investors to a smaller section of the overall market.[12]

5. The economic analysis fails to substantiate the Proposal's purported benefits and ignores several significant costs.

The Proposal's economic analysis fails to quantify or substantiate its purported benefits.[13] Most significantly, the Proposal contends that its changes will save investors "billions" of dollars by reducing public companies' noncompliance[14] and asserts that the annual cost of "corporate fraud" is $830 billion based on a lone academic study.[15] The study is supplemented by a handful of anecdotal reports of individual compliance fines that totaled in the billions.[16] However, the study's estimate is based on a vague and expansive definition of "corporate fraud" and provides no evidence for a connection between the extent of such fraud and prevailing audit standards. Auditors already have a duty to identify and report weaknesses in a company's internal controls that could

[11] *See, e.g.*, 12 CFR § 261.21(b)(3).
[12] COMMITTEE ON CAPITAL MARKETS REGULATION, EXPANDING OPPORTUNITIES FOR INVESTORS AND RETIREES: PRIVATE EQUITY (2022), https://capmktsreg.org/wp-content/uploads/2022/11/Private-Equity-Report-FINAL-1-1.pdf; COMMITTEE ON CAPITAL MARKETS REGULATION, U.S. PUBLIC EQUITY MARKETS ARE STAGNATING (2017), https://capmktsreg.org/wp-content/uploads/2022/11/U.S.-Public-Equity-Markets-are-Stagnating-1.pdf.
[13] Proposal, at 60 *et seq*.
[14] *Id.* at 73.
[15] *Id*. at 63, citing Alexander Dyck et al., *How Pervasive Is Corporate Fraud?* REVIEW OF ACCOUNTING STUDIES 1 (2023).
[16] *Id*. at 64.

result in fraudulent or other material misstatements on companies' financials.[17] The Proposal provides no basis to claim that its modified standards would further reduce any such fraud.

Although the economic analysis acknowledges some of the Proposal's costs in principle, it makes no effort to quantify them. For example, it acknowledges that the Proposal may cause auditors to increase their fees but does not attempt to estimate what these fee increases will amount to.[18] It also completely omits consideration of other significant costs. For example, it does not estimate the costs to U.S. capital markets or investors from further disincentivizing companies from going public. It also does not meaningfully assess the extent to which the Proposal's costs could vary for specific industries, and particularly for companies in the financial sector and other sectors subject to complex regulatory regimes.[19] It also does not consider how the Proposal would disincentivize smaller audit firms from providing services to public companies, due to the higher costs and risk associated with such audits, thus reducing competition in the accounting industry and raising costs for clients. In the absence of a full and adequately quantified consideration of such costs, the economic analysis provides no evidence to conclude that the Proposal's changes would produce a net positive effect for U.S. investors.

6. The Proposal likely exceeds the PCAOB's statutory authority.

The Proposal's radical expansion of the basic responsibilities of auditors likely exceeds the PCAOB's statutory authority. The PCAOB's authority to issue auditing standards derives from the Sarbanes Oxley Act, which requires that the PCAOB's standards relate to "audit reports" and be "necessary or appropriate in the public interest or for the protection of investors."[20] The Supreme Court has held that such authorizing language must be interpreted "reasonably" and in the context of the entire statute.[21]

The Proposal likely exceeds any reasonable interpretation of the statutory language in at least two respects: (1) It requires auditors to monitor and report on issues that ultimately do not affect a company's financials, which exceeds the basic defining features of auditors and "audit reports" – i.e., identifying noncompliance that directly and materially affects the financials; and (2) The PCAOB has articulated no rationale or offered any evidence that the Proposal is "necessary" or "appropriate" for the public interest or the protection of investors. Reading the statutory language in the context of the entire statute, as the Supreme Court requires, only further underscores how the Proposal likely exceeds the PCAOB's authority. Sarbanes-Oxley expressly prohibits auditors from performing "internal audit outsourcing services" and "legal services and expert services unrelated to the audit."[22] The Proposal could conflict with these prohibitions by in effect requiring auditors to provide internal audit outsourcing by duplicating companies' internal compliance and

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[17] PCAOB, *AS 2201: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, https://pcaobus.org/oversight/standards/auditing-standards/details/AS2201.
[18] *Id*. at 78.
[19] *Id*. at 79.
[20] 15 U.S.C. § 7213(a)(1).
[21] *Util. Air Regulatory Group v. E.P.A.*, 573 U.S. 302, 321 (2014).
[22] 15 U.S.C. § 78j-1(g)(5), (8).

control functions and to act as lawyers by assessing legal compliance that does not relate to the financials. The PCAOB's authority to issue auditing standards cannot reasonably be interpreted to encompass standards that conflict with requirements contemplated by directly related statutes.

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III. Conclusion

The Proposal presents no evidence or policy rationale for its radical and costly alterations to prevailing accounting standards. The Proposal would however result in significant cost increases and compliance burdens and will incentivize more companies to avoid U.S. public markets. Moreover, the Proposal's economic analysis fails to substantiate or quantify any of the Proposal's purported benefits or to adequately consider any of its significant costs. Indeed, we note that in voting on the Proposal each of the two PCAOB commissioners who are certified public accountants opposed the Proposal, and expressed many of the same concerns with the Proposal that we do.[23] The Committee therefore calls on the PCAOB to withdraw this Proposal and engage further with key stakeholders, including audit firms and public companies, before issuing a revised proposal that increases audit quality and protects investors' interests through tailored and practicable reforms.

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Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott (hscott@law.harvard.edu), or its Executive Director, John Gulliver (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,

John L. Thornton
Co-CHAIR

Hal S. Scott
PRESIDENT

R. Glenn Hubbard
Co-CHAIR

[23] Christina Ho, Board Member, *Statement on Proposed Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations* (June 6, 2023), https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-auditing-standards-related-to-a-company-s-noncompliance-with-laws-and-regulations; Duane M. DesParte, Board Member, *Statement on Proposal to Amend PCAOB Auditing Standards Related to a Company's Noncompliance with Laws and Regulations and Other Related Amendments* (June 6, 2023), https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposal-to-amend-pcaob-auditing-standards-related-to-a-company-s-noncompliance-with-laws-and-regulations-and-other-related-amendments.